PAPER – 7: DIRECT TAX LAWS & INTERNATIONAL TAXATION

*Question No.**1** is compulsory.*

*Answer any **four** questions from the remaining **five** questions.*

Working notes should form part of the respective answers.

*All questions relate to **Assessment Year 2018-19**, unless stated otherwise in the question.*

Question 1

(a) M/s. Hind Udyog, a manufacturing partnership firm, consisting of three partners namely X, Y and Z, provides following information relating to the year ending on 31.03.2018:

Net profit of ₹ 28.75 lakhs, as per profit and loss account, was arrived at after debiting/crediting the following items:

(i) The firm had provided an amount of ₹ 2 lakhs being sum estimated as payable to workers based on agreement to be entered with the workers union towards periodical wage revision once in three years. The provision is based on a fair estimation on wage and reasonable certainty of revision once in three years.

(ii) Sale proceeds of import entitlements amounting to ₹ 1 lakh have been credited to profit and loss account, which the firm claims as capital receipt not chargeable to income tax.

(iii) Goods and Service Tax demand paid includes an amount of ₹ 5,300 charged as penalty for delayed filing of returns and ₹ 12,750 towards interest for delay in deposit of tax.

(iv) A free air ticket was provided by a supplier for reaching a certain volume of purchase during the F.Y. 2017-18. The same is not credited in profit & loss account because it was encashed by the firm for ₹ 2 lakhs in April 2018.

(v) Interest amounting ₹ 20,000 paid to X as a Karta of HUF @ 18% per annum.

(vi) The firm had taken on lease an old building for the purpose of locating its business. Due to old age of building, it was demolished and a new building put up, which was used by the firm from September, 2017. The cost of new building ₹ 10 lakh was written off as revenue expenditure. The lessor permitted the firm to have an extension of the lease by another 20 years.

(vii) Loss incurred in transactions of purchase and sale of shares (without delivery) of various companies ₹ 3 lakhs.

The Suggested Answers for Paper 7: Direct Tax Laws and International Taxation are based on the provisions of direct tax laws as amended by the Finance Act, 2017. The relevant assessment year is A.Y.2018-19.

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(viii) *A scheduled bank sanctioned and disbursed a term loan in the financial year 2014-15 for a sum of ₹ 50 lakhs. Interest of ₹ 8 lakhs was in arrears. The bank has converted the arrear of interest into a new loan repayable in 10 equal instalments. During the year, the company has paid 2 instalments and the amount so paid has been reduced from Funded Interest in the Balance Sheet.*

The firm furnishes following additional information relating to it:

(1) *Provision for audit fees ₹ 2.5 lakhs was made in the books for the year ended on 31.03.2017 without deducting tax at source. Such fees was paid to the auditors in September, 2017 after deducting tax under section 194J and the tax so deducted was deposited on 7th October, 2017.*

(2) *The firm had made an investment of ₹ 23 lakhs and ₹ 12 lakhs on the construction of two warehouses (excluding the cost of land), in rural areas for the purpose of storage of agricultural produce and edible oil respectively. These were made available for use from 15.09.2017. The profits from setting of these warehouses (before claiming deduction under section 35AD and 32) for the A.Y. 2018-19 is ₹ 15 lakhs and ₹ 5 lakhs respectively.*

(3) *In July, 2017 firm received a dividend of ₹ 11 lakhs from A Ltd. in which it holds 10% of shares.*

Compute the total income of M/s Hind Udyog for the A.Y. 2018-19 by analysing, integrating and applying the relevant provisions of Income tax law. Explain in brief, the reasons for the treatment of each item. ***(14 Marks)***

(b) *Red Ltd., a non-resident foreign company, had entered into a collaboration agreement, approved by the Central Government, with Blue Ltd., an Indian company on February 21, 2003 and is in receipt of following payments during the previous year ending on March 31, 2018:*

(i) *Interest on 8% debentures for ₹ 40 lakhs issued by Blue Ltd. on July 1, 2017 in consideration of providing of technical know-how, manufacturing process and designs (date of payment of interest being March 31 every year).*

(ii) *Service charges @2.5% of the value of plant and machinery for ₹ 500 Lakhs leased out to Blue Ltd. payable each year before March 31.*

(iii) *Apart from the above incomes, Red Ltd. received a long term capital gain amounting to ₹ 1.90 Lakhs on sale of debentures of Green Ltd., an Indian company, subscribed in US$.*

Compute the Total Income of Red Ltd. and determine its tax liability for the assessment year 2018-19. ***(6 Marks)***

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Answer

(a) Computation of Total Income of M/s Hind Udyog for the A.Y.2018-19

Particulars	Amount (₹)		
Profits and gains from business or profession			
Profits and gains from regular business			
Net profit as per the profit and loss account		28,75,000	
Add: **Items debited but to be considered separately or to be disallowed/ amount taxable but not credited**			
(i) **Provision for wages payable to workers** [Since the provision is based on a fair estimate of wages payable with reasonable certainty, the provision is allowable as deduction. ICDS X requires a reliable estimate of the amount of obligation and reasonable certainty for recognition of a provision, which is present in this case. As the provision of ₹ 2 lakhs has been debited to profit and loss account, no adjustment is required while computing business income]	-		
(iii) **Penalty for delayed filing of GST returns** [Penalty imposed for delay in filing GST return is not deductible since it is on account of infraction of the law requiring filing of the return within the specified period[1]. Since the same has been debited to profit and loss account, the same is required to be added back while computing business income]	5,300		
(iii) **Interest for delay in deposit of GST** [Interest paid on delayed deposit of GST is not penal in nature but is compensatory in character and is an allowable deduction	-		

[1] *CIT v. Ratanchand Bholanath (S.S) (1986) 160 ITR 500 (M.P.)*

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	under section 37[2]]		
(iv)	**Free air ticket provided by a supplier** [Value of free air ticket provided by a supplier is taxable as business income under section 28, as the value of any benefit, whether convertible into money or not, arising from business is taxable as business income. Since the same is not credited to profit and loss account, the same is required to be added while computing business income]	2,00,000	
(v)	**Interest paid to X as Karta of HUF** [Where an individual is a partner in a firm otherwise than in a representative capacity, the provisions of section 40(b) shall not apply to any interest payable by the firm to such individual on behalf of any other person. Hence, assuming that the provisions of section 40A(2) do not get attracted in this case, such interest shall be allowed as deduction in full even though the interest rate is more than 12% p.a.]	-	
(vi)	**Cost of new building** [Cost of new building is not allowed as deduction since it is capital in nature. Since the same has been debited to profit and loss account, it has to be added back]	10,00,000	
(vii)	**Loss from trading in shares [without delivery]** [Loss incurred on purchase and sale of shares of other companies without delivery is a speculative transaction. Since the same is debited to profit and loss account, the same is required to be added back while computing business income]	3,00,000	15,05,300
			43,80,300

[2] Supreme Court in *Lachmandas Mathurdas v. CIT (2002) 254 ITR 799*

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	***Less:* Items credited to profit and loss account, but not includible in business income/ permissible expenditure and allowances**			
(ii)	**Sale proceeds of import entitlements** [Sale of import entitlements gives rise to profits or gains taxable under section 28. Since the amount has already been credited to profit and loss account, no further adjustment is required]	-		
(vi)	**Depreciation as per Income-tax Rules, 1962 on building [₹ 10 lakhs x 10%]** [Where any capital expenditure is incurred by the assessee for the purposes of the business by way of construction of any structure or doing of any work by way of renovation, extension or improvement to the building which is not owned by him but in respect of which the assessee holds a lease, then, depreciation would be allowed as if the said structure or work is a building owned by the assessee.]	1,00,000		
(viii)	**Payment of new loan converted from arrear interest** [Conversion of unpaid interest into loan shall not be construed as payment of interest for the purpose section 43B. The amount of unpaid interest converted into a new loan will be allowable as deduction only in the year in which such converted loan is actually paid. Since ₹ 1,60,000 (₹ 8,00,000/10 x 2) has been paid in the P.Y. 2017-18, the same would be allowed as deduction] ***Note:*** *Since the question specifies that the* ***"net profit was arrived at after debiting/crediting the following items",*** *₹ 8 lakhs, being interest in arrears, has to be added back, on the basis of the assumption that it has been already debited in the profit and loss account and then reduced ₹ 1,60,000, being interest*	1,60,000		

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deduction allowable. In such case income will increase by ₹6,40,000			
A(1) Audit fees of P.Y. 2016-17 [30% of ₹ 2,50,000, being the audit fees disallowed in the P.Y. 2016-17 for non-deduction of TDS in the P.Y. 2016-17 would be allowed in the year of deduction and payment of TDS i.e., P.Y. 2017-18]	75,000	3,35,000	
			40,45,300
Profits and gains from Speculation business			
Loss from the speculation business of trading of shares without delivery [to be carried forward for A.Y. 2019-20 for set-off against profits of any speculative business, assuming the firm has filed the return of income on or before the due date u/s 139(1)].	(3,00,000)		-
Profits and gains from the business of setting up a warehouse for storage of edible oil			
Profit from setting up of warehouse (before providing for depreciation under section 32)		5,00,000	
Less: Depreciation as per Income-tax Rules, 1962 on construction of warehouse [₹12,00,000 x 10%] [Since it is not a specified business under section 35AD]		1,20,000	3,80,000
Profit and gains from the business of setting up a warehouse for storage of agricultural produce			
Profit from setting up of warehouse (before providing deduction under section 35AD)	15,00,000		
Less: Deduction under section 35AD **[100% of capital expenditure** is allowable as deduction, since setting up and operating a warehousing facility for **storage agricultural produce** is **a specified business,** where operations are commenced on or after 01.04.2009]	23,00,000		
Loss from the specified business under section 35AD to be carried forward indefinitely for set-off against profits of the specified business,	(8,00,000)		

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assuming that the firm has filed the return of income on or before the due date under section 139(1)			
Profit and gains from business or profession			**44,25,300**
Income from Other Sources			
Dividend received from A Ltd.			**1,00,000**
[Dividend received from an Indian company is exempt u/s 10(34) to the extent of ₹ 10 lakhs. Balance dividend of ₹ 1 lakh would be chargeable to tax u/s 115BBDA]			
Gross Total income/ Total Income			**45,25,300**

Note - *The number used in the computation are not the serial number but are the number of each of the adjustment or of additional information given there against in the question.*

(b) Computation of total income of Red Ltd., a foreign company, for A.Y.2018-19

Particulars	₹
Fees for technical services	40,00,000
Debentures issued by Blue Ltd. in consideration for provision of technical know-how by Red Ltd., a foreign company, is in the nature of fee for technical services, deemed to accrue or arise in India to Red Ltd., a foreign company	
Royalty	12,50,000
Service charges for leased out plant and machinery [₹ 500 lakhs x 2.5%] [Service charges paid by Blue Ltd. for leased out plant and machinery is in the nature of royalty, which is deemed to accrue or arise in India to Red Ltd., a foreign company]	
Capital Gains	
Long term capital gain on sale of debentures of Green Ltd. an Indian company	1,90,000
Interest on debentures	
Interest on debentures [₹40 lakhs x 8% x 9/12] [Iinterest on debentures of Blue Ltd., an Indian company, is deemed to accrue or arise in India, since the debt incurred is not used for a business outside India or for earning income from a source outside India]	2,40,000
Total Income	**56,80,000**

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Computation of tax liability of Red Ltd. for A.Y.2018-19

Particulars	₹
Tax@10% on royalty of ₹12.50 lakhs and **fees for technical services** of ₹ 40 lakhs	5,25,000
Tax @20% on long term capital gains of ₹ 1,90,000, assuming debentures are listed on recognised stock exchange	38,000
Tax @40% on interest on debentures of ₹ 2,40,000 since debt is not incurred by Blue Ltd. in foreign currency	96,000
	6,59,000
Add: Education cess and SHEC@3%	19,770
Tax Liability	**6,78,770**

Note *– The above answer is based on the assumption that debentures of Green Ltd. are listed on a recognized stock exchange. However, question can also be answered on the basis of the assumption that the debentures are not listed on recognized stock exchange. In such case, long term capital gains on sale of debentures would be subject to tax @10% and tax thereon shall be ₹ 19,000/- and total tax liability of Red Ltd. would be ₹ 6,59,200/-.*

Question 2

(a) Anustup Chandra Flour Mills Ltd., a domestic company engaged in manufacture of wheat flour, furnishes the following information pertaining to the year ended 31-3-2018:

(i) Net profit as per the Statement of Profit and Loss is ₹ 77 lakhs after considering the items listed in (ii) to (vi) below.

(ii) The company is a member of Vishnu Foods & Co., an AOP in which the members' shares are determinate and their shares in profit/loss are clearly known. The entire income of the AOP is from business activities. During the year, the company has derived share income of ₹ 9 lakhs from the AOP. The company has spent a sum of ₹ 90,000 towards earning such income.

(iii) The company has provided for income-tax (including interest under sections 234B and 234C of ₹ 62,000) for ₹ 3 lakhs and ₹ 5 lakhs towards share in loss of foreign subsidiary.

(iv) Amount debited to the Statement of Profit and Loss towards interest to a public financial institution is ₹ 12 lakhs. Of this, ₹ 4 lakhs was paid on 12-12-2017 only.

(v) The company committed breach of building norms while extending the factory building. The City Corporation initiated proceedings against the company and the company settled the issue by paying compounding fee of ₹ 1 lakh. This amount forms part of general expenses, which has been debited to the Statement Profit and Loss.

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(vi) In the administrative expenses, the company has debited a sum of ₹ 70,000 towards fee for delayed filing of statement of TDS under section 234E of the Income-tax Act, 1961.

(vii) The company has credited revaluation surplus of ₹ 10 lakhs on fair valuation of assets under Ind AS 16 and Ind AS 38 to other equity.

(viii) The company has credited ₹ 5 lakhs to other comprehensive income on fair valuation of equity instruments in which the company has Investment.

During the current year, the depreciation charged as per books of account of the company is the same as allowable under the Income-tax Act, 1961 [before considering the provisions of section 32(2)]. The company proposes to adopt this practice consistently in the future years.

You are required to compute the income-tax payable by the company for the assessment year 2018-19. The company is an Indian Accounting standard compliant company.

Note:** The Turnover of company for the P.Y 2015-16 was ₹ 50 crore.* ***(14 Marks)

(b) Mr. Manav, a resident, has derived certain income from a nation Q with which no DTAA exists. In Q, any income chargeable to tax is charged at a flat rate of 18%.

Mr. Manav has derived the following income from Q:

(i) Agricultural income from lands in Q ₹ 14 lakhs

(ii) Share income from a partnership firm in Q ₹ 18 lakhs

In nation Q, agricultural income is exempt and does not form part of total income.

State with reasons, whether, Mr. Manav (assessee) can claim double taxation relief in respect of the above two items of income and also determine the quantum of double taxation relief available.

The "Indian rate of tax" may be taken as 20%. ***(6 Marks)***

Answer

(a) Computation of Total Income of Anustup Chandra Flour Mills Ltd. as per the normal provisions of the Act for A.Y. 2018-19

Particulars	₹	₹
Net Profit as per statement of profit and loss		77,00,000
Add: **Items debited but to be considered separately or to be disallowed/amount taxable but not credited**		
(ii) Expenditure on earning share income in AOP	90,000	
[Share income in AOP, which pays tax at the maximum marginal rate is exempt in the hands of the member. Consequently, expenditure incurred on earning exempt income		

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	is not allowable as deduction. Since the same has been debited in the statement of profit and loss, it has to be added back]	
(iii)	**Provision of income-tax (including interest u/s 234B and 234C)** [Provision of income-tax is not allowable as deduction. Also, any interest payable for default committed by the assessee for discharging his statutory obligations under Income-tax Act, 1961 which is calculated with reference to the tax on income is not allowable as deduction. Since the provision and interest have been debited to statement of profit and loss, they have to be added back][3]	3,00,000
(iii)	**Provision for loss of foreign subsidiary** [Since the loss of foreign subsidiary is not a loss incurred for the purpose of business of the assessee, it is not allowed while computing business income. Since the same has been debited in the statement to profit and loss, it has to be added back]	5,00,000
(iv)	**Interest to a public financial institution** [Deduction of any sum, being interest payable on any loan or borrowing from a public financial institution shall be allowed, if such interest has been actually paid. Since ₹ 4 lakhs has been paid on 12.12.2017, the balance ₹ 8 lakhs debited to statement of profit and loss has to be added back, assuming that such sum is not paid on or before due date of filing of return of income]	8,00,000
(v)	**Compounding fee paid for violation of building norms** [The amount paid for compounding an offence is inevitably a penalty and the mere fact that it has been described as compounding fee cannot, in any way, alter the character of the payment which is in the nature of penalty. Hence, the same is not allowable as revenue expenditure[4]. Since the same has been debited to statement of profit and loss, it has to be added back]	1,00,000
(vi)	**Fee for delayed filing of statement of TDS** [Under section 37, any expenditure incurred wholly and exclusively for the purpose of business or profession is	-

[3] *Bharat Commerce and Industries Ltd. v. CIT [1998] 230 ITR 733 (SC)*

[4] *Millenia Developers P Ltd. v. Deputy CIT (2010) 322 ITR 401 (Kar.)*

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allowed as deduction. The fee for delayed submission of the statement of TDS is not in the nature of interest for delayed remittance of TDS or in the nature of penalty, which are not allowable as deduction while computing business income.[5] Hence, it is allowable as deduction. Since the same has been debited to statement of profit and loss, no further adjustment is required]		
(vii) Revaluation surplus on fair valuation of assets under Ind AS 16 and 38 credited to other equity [No treatment is required under the regular provisions of the Income-tax Act, 1961. Since the same has not been credited to statement of profit and loss, no adjustment is required]	-	
(viii) Fair valuation of equity instruments [No treatment is required under the regular provisions of the Income-tax Act, 1961. Since the same has not been credited to statement of profit and loss, no adjustment is required]	-	17,90,000
		94,90,000
***Less:* Items credited to statement of profit and loss, but not includible in business income/ permissible expenditure and allowances**		
(ii) Share income in AOP [Where a company is a member in an AOP, the AOP would have to pay tax at the maximum marginal rate owing to which, company's share in the total income of AOP will not be included in its total income and will be exempt. Since the same has been credited to the statement of profit and loss, the same has to be reduced while computing business income]		9,00,000
Total income		**85,90,000**

Computation of book profit under section 115JB for A.Y. 2018-19

Particulars	₹	₹
Net profit as per the statement of profit and loss		77,00,000
Add: **Net profit to be increased by the following amounts as per *Explanation 1* to section 115JB(2):**		
(ii) **Expenditure on earning share income in AOP**	90,000	

[5] The late fee levied u/s 234E is just like a fee payable to the ROC for delayed filing of a statutory return under the Companies Act, 2013. Just as the latter is an allowable expenditure, the former also is.

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[Expenditure related to share income in AOP has to be added back while computing the book profit, since no income-tax is payable by the company on share income in AOP]		
(iii) **Provision of income-tax (including interest under section 234B and 234C)**	3,00,000	
[Income-tax shall include, *inter alia*, any interest charged under the Act, therefore, whole of the amount of provision for income-tax including ₹ 62,000 towards interest payable has to be added]		
(iii) **Provision for loss of foreign subsidiary**	5,00,000	8,90,000
[Provision for losses of subsidiary companies has to be added back]		
		85,90,000
Less: **Net profit to be decreased by the following amounts as per *Explanation 1* to section 115JB(2):**		
(i) Share income in AOP		9,00,000
[Share income of company in AOP has to be reduced while computing the book profit, since no income-tax is payable by the company on share income in AOP]		
Book profit computed in accordance with *Explanation 1* to section 115JB(2)		76,90,000
***Add:* Items credited to OCI that will not be reclassified to profit or loss:**		
(vii) **Revaluation surplus** on fair valuation of assets ₹ 10 lakhs [Book profit not to be increased by revaluation surplus for assets]		-
(viii) **Income on fair valuation of equity instruments** of ₹ 5 lakhs [Book profit not to be increased by income in fair values of equity instruments]		-
Book Profit for levy of MAT		**76,90,000**

Computation of tax liability for A.Y. 2018-19

Particulars	₹
Minimum Alternate Tax on book profit under section 115JB = 18.5% of ₹ 76,90,000	14,22,650
Income-tax computed as per the normal provisions of the Act [₹ 85,90,000 x 25% since, the turnover of the company for the P.Y. 2015-16 does not exceed ₹ 50 crores]	21,47,500

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Since the income-tax liability of ₹ 21,47,500 is higher than the MAT liability of ₹ 14,22,650, the income-tax liability would be computed as per the normal provisions of the Income-tax Act,1961:	
Income-tax computed as per the normal provisions of the Act	21,47,500
Add: Education cess and SHEC@3%	64,425
Tax Payable	**22,11,925**
Tax Payable (rounded off)	**22,11,930**

Note - *The number used in the computation are not the serial number but are the number of each of the adjustment or of additional information given there against in the question.*

(b) Mr. Manav is resident in India for the P.Y.2017-18, his global income would be subject to tax in India.

Agricultural income from lands located outside India would not be exempt from income-tax in India under section 10(1) in the hands of a resident. The said income would be chargeable to tax in his hands in India.

Share income from a partnership firm in County Q would not be exempt from income-tax in India under section 10(2A) in the hands of a partner. The same would be chargeable to tax in his hands in India.

Thus, both the above items of income are chargeable to tax in India in the hands of Mr. Manav.

The following are the conditions to be fulfilled for claiming benefit deduction under section 91:-

(i) Mr. Manav should be a resident in India during the relevant previous year.

(ii) The income accrues or arises to him outside India during that previous year.

(iii) Such income is not deemed to accrue or arise in India during the previous year.

(iv) Both the income given in question has been subjected to income-tax in Country Q in his hands and he has paid tax on such income in Country Q.

(v) There is no agreement under section 90 for the relief or avoidance of double taxation between India and Country Q, where the income has accrued or arisen.

Since all the conditions mentioned above are fulfilled, Mr. Manav is eligible for deduction under section 91 in respect of double taxed income i.e., share income from a firm in County Q.

However, he would not be eligible for deduction under section 91 in respect of agricultural income from lands in Country Q since such income is exempt in Country Q and consequently, is not a doubly taxed income.

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Mr. Manav is entitled for deduction under section 91 of a sum calculated on share income from firm in Country Q at the Indian rate of tax (20%) or the rate of tax in Country Q (18%), whichever is lower.

Accordingly, deduction under section 91 available to Mr. Manav would be ₹ 3,24,000, being 18% of ₹ 18,00,000.

Note *- It is logical to take a view that exemption under section 10(2A) in hands of the partner would be available only in respect of share income from an Indian firm. In this case, since the share income is from a foreign firm, the same is taxable in India in the hands of the partner. The above solution has been worked out on the basis of this view.*

An alternate view that the share income from foreign firm is also exempt under section 10(2A) may also be possible, in which case, Mr. Manav would not be eligible for any deduction under section 91, since there would be no double taxed income.

Question 3

(a) Eden Fabs Private Ltd. went into liquidation on 31.07.2017. The company was seized and possessed of the following funds prior to the distribution of assets to the shareholders:

	₹
Share capital (issued on 01.04.2012)	*8,00,000*
Reserves prior to 31.07.2017	*4,00,000*
Excess realization in the course of liquidation	*6,00,000*
Total	***18,00,000***

There are 8 shareholders, each of whom received ₹ 2,25,000 from the liquidator in full settlement. You are required to examine the various issues and advice the shareholders about their liability to Income tax. ***(6 Marks)***

(b) Mani foundations, a charitable trust registered under section 12AA of the Income-tax Act, 1961, run schools for primary and secondary education. The following particulars pertaining to the previous year 2017-18 are furnished to you by the trust:

		₹ (in lakhs)
(i)	*Gross receipts from students towards tuition fees, development fees, laboratory fees etc.*	*200*
(ii)	*Voluntary contributions received from public (including anonymous donation ₹5 lakhs)*	*25*
(iii)	*Government grants*	*8*
(iv)	*Donation given towards corpus to a trust registered under section 10(23C)*	*2*

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(v)	*Amount applied for the purpose of schools*	*90*
(vi)	*Included in (v) above, a sum of 5 lakhs, being the amount applied for the benefit of the founder of the trust.*	
(vii)	*The trust set apart ₹ 55 lakhs for acquiring a building to expand its schools. But the amount was paid in December 2018 when the sale deed was registered in its name*	
(viii)	*Excess of expenditure over income in the previous year 2016-17*	*25*

Compute the total income of the trust for the assessment year 2018-19 in order to avail maximum benefits within the four corners of law. ***(8 Marks)***

(c) State with reasons, whether Netlon LLC., (Incorporated in Singapore) and Briggs Ltd., a domestic company, are/can be deemed to be associated enterprises for the transfer pricing regulations (Each situation is independent) of the others:

(i) Netlon LLC. has advanced a loan of ₹ 53 crores to Briggs Ltd. on 12-1-2018. The total book value of assets of Briggs Ltd. is ₹ 100 crores. The market value of the assets, however, is ₹ 150 crores. Briggs Ltd. repaid ₹ 10 crores before 31-3-2018.

(ii) Netlon LLC. has the power to appoint 2 of the directors of Briggs Ltd, whose total number of directors in the Board is 4.

(iii) Total value of raw materials and consumables of Briggs Ltd. is ₹ 900 crores. Of this, Netlon LLC. supplies to the tune of ₹ 820 crores, at prices mutually agreed upon once in six months and depending upon the market conditions. ***(6 Marks)***

Answer

(a) Where the assets of a company are distributed to its shareholders on its liquidation, such distribution shall not be regarded as transfer in the hands of the company for the purpose of section 45.

However, where the shareholder, on liquidation of a company, receives any money or other assets from the company, he shall be chargeable to income-tax under the head "capital gains", in respect of the money so received or the market value of the other assets on the date of distribution as reduced by the amount of dividend deemed under section 2(22)(c) and the sum so arrived at shall be deemed to be the full value of the consideration for the purposes of section 48.

As per section 2(22)(c), dividend includes any distribution made to the shareholders of a company on its liquidation, to the extent to which the distribution is attributable to the accumulated profits of the company immediately before its liquidation, whether capitalized or not.

In this case, one-eighth share in the distribution made to a shareholder attributable to the accumulated profits immediately before liquidation would be deemed dividend under section 2(22)(c). The same is exempt under section 10(34) in the hands of the

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shareholder, since the company, Eden Fabs Pvt. Ltd., is liable to dividend distribution tax in respect of the same.

Therefore, ₹ 2,25,000 minus deemed dividend under section 2(22)(c) would be the full value of consideration in the hands of each shareholder. Against this, the indexed cost of acquisition computed by applying the relevant CII to the cost of acquisition of ₹ 1,00,000 of each shareholder [i.e., ₹ 8,00,000/8] is to be deducted to arrive at the long-term capital gains. Since the shares are held for more than 24 months, they constitute a long-term capital asset

Since the equity shares are not listed, securities transaction tax would not have been paid and hence, the capital gain (long term) is not exempt under section 10(38). The benefit of concessional rate of tax @10% without indexation benefit would also not be available. Hence, such long term capital gain would be taxable @ 20% with indexation benefit.

Therefore, the shareholders have to be advised that capital gains tax liability would arise in their hands, the same should be computed in the manner given above and would be subject to tax@20%.

(b) Computation of total income of Mani Foundations for the A.Y.2018-19

Particulars	₹	₹
Gross receipts from students towards tuition fees, development fees etc.		2,00,00,000
Government Grants (taxable, since only grant for the purpose of corpus of a trust established by the Central or State Government is excluded from the definition of income)		8,00,000
[***Note -*** *Government Grants would be exempted based on the assumption that Mani Foundations is set up by the Central or State Government and the grant is towards the corpus of the trust]*		
Voluntary contributions (other than anonymous donations) [₹ 25 lakh – ₹ 5 lakh]		20,00,000
		2,28,00,000
Add: Anonymous donations [to the extent not chargeable to tax@30% under section 115BBC(1)(i)] **[See Note below]**		1,25,000
		2,29,25,000

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Less: 15% of income eligible for being set apart without any condition[6]		34,38,750
		1,94,86,250
Less: Amount applied for charitable purposes		
- Amount applied for the purpose of schools (excluding amount applied for the benefit of the founder) = ₹ 90 lakh – ₹ 5 lakh	85,00,000	
- Amount set apart for acquiring a building to expand its schools	55,00,000	
[The word "applied" used in section 11 means that the income is actually applied for the charitable purposes of the trust. The word "applied" does not necessarily imply "spent". Even if a certain amount is irretrievably earmarked and allocated for charitable purposes, the said amount can be deemed to have been applied for charitable purposes.[7]]		
- Corpus donations to a trust registered under section 10(23C) [Deduction is not permissible only in respect of corpus donations to a trust registered u/s 12AA]	2,00,000	
- Excess of expenditure over income in the P.Y.2016-17	25,00,000	1,67,00,000
		27,86,250
Add: Amount applied for the benefit of the founder of the trust chargeable to tax under section 12(2) read with section 13(6)		5,00,000
Anonymous donation taxable @30% under section 115BBC(1)(i) **[See Note below]**		3,75,000
Total Income of the trust (including anonymous donation taxable@30%)		**36,61,250**

Note *- As per section 115BBC(1)(i), the anonymous donations in excess of the higher of the following would be subject to tax@30%;*

- ₹1.25 lakh, being 5% of the total donations received i.e., 5% of ₹25 lakh; or ₹1 lakh

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[6] As per the Supreme Court ruling in *CIT v. Programme for Community Organisation (2001) 116 Taxman 608,* 15% of gross receipts would be eligible for accumulation under section 11(1)(a).

[7] It was so held in *CIT vs. Trustees of H.E.H. Nizams Charitable Trust, (1981) 131 ITR 497 (AP).*

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Therefore, anonymous donations of ₹ 3.75 lakh (₹ 5 lakh – ₹ 1.25 lakh) would be subject to tax@30% under section 115BBC(1)(i).

Such anonymous donations which are subject to tax@30% are not eligible for the benefit of exclusion from total income under sections 11 and 12.

***[Alternate Answer]** – As per the plain reading of section 13(7), it is possible to take a view that the entire anonymous donations may not be eligible for benefit of exclusion from total income under sections 11 and 12. If this view is taken, then ₹ 1.25 lakhs should not be added to ₹ 228 lakhs. Accordingly, ₹ 34.20 lakhs, being 15% of ₹ 228 lakhs would be the income eligible for accumulation without any condition. The total income of the trust (including anonymous donations) would be ₹ 36.80 lakhs.*

(c) **(i)** Netlon LLC, a foreign company, has advanced loan of ₹ 53 crores to Briggs Ltd., a domestic company, which amounts to 53% of book value of assets of Briggs Ltd. Since the loan advanced by Netlon Inc. is not less than 51% of the book value of assets of Briggs Ltd., Netlon Inc. and Briggs Ltd. are deemed to be associated enterprises for the transfer pricing regulations.

The deeming provisions would be attracted even if there is a repayment of loan during the same previous year which brings down his percentage below 51%.

(ii) Netlon LLC has the power to appoint 50% (2 out of 4) of the directors of Briggs Ltd.

Two enterprises would be deemed to be associated enterprises if more than half of the board of directors of one enterprise are appointed by the other enterprise.

In this case, since Netlon LLC has the power to appoint exactly half (and not more than half) of the directors of Briggs Ltd., they are not deemed to be associated enterprises.

(iii) Even though Netlon LLC supplies 91.11% of the raw materials and consumables required by Briggs Ltd. which is more than the specified threshold of 90%, Netlon LLC and Briggs Ltd. are not deemed to be associated enterprises

Reason for not deemed to be associated enterprises is since the price of supply is not influenced by Netlon LLC but is mutually agreed upon once in six months depending upon prevailing market conditions.

Question 4

(a) Tulsi Private Ltd., a company engaged in ship breaking activity, sold some old and used plates, wood etc., in respect of which it did not collect tax from the buyer. The company claimed that such items are usable as such. Hence these are not 'scrap' to attract the provisions for collection of tax at source. The Assessing Officer treated such items in the nature of 'scrap' and raised a demand under section 201(1) and interest under section 201(1A).

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Is the action of the Assessing Officer in treating such items as 'scrap' tenable in law? Discuss. ***(4 Marks)***

(b) Discuss whether liability to deduct tax at source arises in the under-mentioned (independent) situations in respect of following payments made by residents in India:

(i) Dindayal & Co., a partnership firm, has credited a sum of ₹ 67,000 and ₹ 4,000 respectively, as interest to partners L (Resident in India) and M (non-resident) respectively. ***(4 Marks)***

(ii) Lumnous Pvt. Ltd., whose accumulated profits are ₹ 20 lakhs, wants to disburse a loan of ₹ 25 lakhs to Mrs. Nisha, a resident shareholder holding 20% of the equity shareholding in the company. Can the entire amount of loan be disbursed to the shareholder, keeping in mind the provisions of the Income-tax Act, 1961? The Finance Manager feels that this being a pure loan transaction, there is no bar for disbursing the entire amount. Is his view correct? ***(4 Marks)***

(iii) Payment of ₹ 5 lakhs made by Shiv & Company (partnership firm) to Jyoti & Company Ltd. for organising debate competition on the subject 'Rural Heritage of Rajasthan'. ***(2 Marks)***

(c) "Every jurisdiction, in the domestic law, prescribes the mechanism to determine residential status of a person. In case, a person is considered to be resident of both contracting states, it becomes necessary to apply the tie-breaker rule."

Discuss the manner for application of the tie-breaker rule. ***(6 Marks)***

Answer

(a) The issue under consideration in the present case is, can items which are usable as such be treated as "Scrap" to attract provisions for tax collection at source under section 206C.

The waste and scrap must be from manufacture or mechanical working of material which is definitely not usable as such because of breakage, cutting up, wear and other reasons.

Any material which is usable as such would not fall within the ambit of the expression scrap. In case of a company engaged in ship breaking activity, the old and used plates, wood etc. are usable as such. Since the items in question were usable as such, therefore, they do not fall within the definition of "scrap"

Thus, in the present case, the action of Assessing Officer in treating such items in the nature of scrap and raising a demand under section 201(1) and interest under section 201(1A), is not tenable in law.

Note – *The facts of the case given are similar to the facts in CIT v. Priya Blue Industries (P) Ltd (2016) 381 ITR 210, wherein the above issue came up before the Gujarat High Court. The answer is based on the rationale of the Gujarat High Court in the said case.*

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(b) (i) Section 194A requiring deduction of tax at source on any income by way of interest, other than interest on securities credited or paid to a resident, excludes from its scope, income credited or paid by a firm to its partner.

Section 195 which requires tax deduction at source on payment to non-residents, does not provide for any exclusion in respect of payment of interest by firm to its non-resident partner.

Therefore, Dindayal & Co., a partnership firm is not required to deduct tax at source under section 194A on the amount of interest of ₹ 67,000 credited to the account of L, resident in India.

Tax at source under section 195 @ 30.9% [30%, being the rate in force + cess@3%] in respect of interest of ₹ 4,000 credited to the account of M, a non-resident is required to be deducted.

(ii) As per section 2(22)(e), the loan amount of ₹ 25,00,000 disbursed by Lumnous Pvt. Ltd. a company in which the public are not substantially interested to Mrs. Nisha, being a shareholder holding not less than 10% (20%, in the present case) of the equity shares of the company would be deemed as dividend to the extent of accumulated profits of ₹ 20,00,000.

₹ 20,00,000 would be deemed as dividend in the hands of Mrs. Nisha, and therefore, would be chargeable to tax in her hands.

Consequently, Lumnous Pvt. Ltd. would be required to deduct tax at source under section 194 at the rates in force i.e., deduct tax of ₹ 2,00,000, being 10% on the deemed dividend of ₹ 20,00,000, since such amount exceeds the threshold limit of ₹ 2,500. Only the balance amount of ₹ 23,00,000 [i.e., ₹ 25,00,000 – ₹ 2,00,000] can be disbursed to the shareholders.

Thus, the view of the Finance Manager that this being a pure loan transaction, the entire amount can be disbursed is incorrect. Only the balance amount of ₹ 23,00,000, after deducting tax of ₹ 2,00,000 at source on deemed dividend of ₹ 20,00,000, can be disbursed.

(iii) The services of event managers in relation to sports activities alone have been notified by the CBDT as "professional services" for the purpose of section 194J. In this case, payment of ₹ 5 lacs was made to Jyoti & Company Ltd., an event management company for organization of a debate competition. Hence, the provisions of section 194J are not attracted in this case.

However, TDS provisions under section 194C relating to contract payments would be attracted and consequently, tax has to be deducted @2% under section 194C.

(c) The tie-breaker rule would be applied in the following manner:

(i) The first test is based on where the individual has a permanent home i.e., a dwelling place available to him at all times continuously and not occasionally.

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(ii) If the individual has permanent home available to him in both Contracting States, he will be considered a resident of the Contracting State where his personal and economic relations are closer, in other words, the place where lies his centre of vital interests.

Thus, preference is given to family and social relations, occupation, place of business, place of administration of his properties, political, cultural and other activities of the individual.

(iii) In a case where the individual has a permanent home available to him in both Contracting States and it is not possible to determine in which one he has his centre of vital interests; and in a case where the individual has a permanent home available to him in neither Contracting State, preference is given to the Contracting State where the individual has an habitual abode.

(iv) If the individual has habitual abode in both Contracting States or in neither of them, he shall be treated as a resident of the Contracting State of which he is a national.

(v) If the individual is a national of both or neither of the Contracting States, the matter is left to be considered by the competent authorities of the respective Contracting States.

Question 5

Attempt Either 5(a)(i) OR 5(a)(ii)

(a) (i) The business premise of Mr. Rajneesh was subjected to a survey under section 133A of the Act. There were some indiscriminating materials found at the time of survey. The assessee apprehends reopening of assessments of the earlier years. He wants to know whether he can approach the Settlement Commission.

Explain briefly the basic conditions to be satisfied and the benefits that may accrue to Mr. Rajneesh by approaching the Settlement Commission. ***(5 Marks)***

(ii) The assessment of Foundation Bank Ltd. for Assessment Year 2014-15 was made under section 143(3) on 30th November, 2015 allowing deduction under section 36(1)(vii) and deduction in respect of foreign exchange rate difference as claimed in the return of income. Subsequently, two notices of reassessment were issued under section 148 and an order of reassessment was passed under section 147 on 31st December, 2017 which did not deal with the above deductions. Later the Principal Commissioner after examining the records of assessment, initiated revisionary proceeding under section 263 on 31st May, 2018 for disallowing deduction under section 36(1)(vii) and deduction in respect of foreign exchange rate difference. The bank claims that the order passed by the Principal Commissioner under section 263 is barred by limitation.

Is the claim made by Foundation Bank tenable in law? ***(5 Marks)***

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(b) *State with brief reason, whether the following statements are true or false:*

(No mark will be awarded for answers without reason.)

(i) *Where a notice under section 143(2) is issued to the assessee, it is not required to process under section 143(1), the return of income filed by the assessee.*

(ii) *Even without rejecting the books of account, if any, maintained by the assessee, the Assessing Officer can make a reference to the Valuation Officer under section 142A for estimating the cost of construction of an immovable property.*

(iii) *Expenses of special audit conducted under section 142 shall be paid by the Central Government.*

(iv) *Only an individual can be regarded as a Tax Return Preparer under section 139B.*

(6 Marks)

(c) *In the course of search operation under section 132 of the Income-tax Act, 1961, in the month of July, 2018, Mr. Khemka has made a declaration under section 132(4) to the Income Tax authorities on the earning of his income not disclosed in respect of previous year 2017-18. Can that statement save Mr. Khemka from a levy of penalty, if he is yet to file his return of income for assessment year 2018-19?* ***(3 Marks)***

(d) *John Butler Tex. Inc., is a company incorporated in Colombo, Sri Lanka. 60% of its shares are held by I Pvt. Ltd., a domestic company. John Butler Tex. Inc. has its presence in India also. The data relating to John Butler Tex. Inc., are as under:*

Particulars	***India***	***Sri Lanka***
Fixed assets at depreciated values for tax purposes (₹ in crores)	*90*	*70*
Intangible assets (₹ in crores)	*40*	*180*
Other assets (₹ in crores)	*30*	*90*
Income from trading operations (₹ in crores)	*15*	*42*
Income from investments (₹ in crores)	*30*	*13*
Number of employees (Residents in respective countries)	*40*	*60*

For POEM purposes, state whether,

(i) *The company shall be said to be engaged in 'active business outside India'.*

(ii) *Because of increased operations in India, more manpower is needed. 30 more employees may be required in this regard. The company can either take these employees directly in its roll or can outsource the increased operation to an external agency which will engage the 15 employees in its roll and finish the work for the company. Which choice will be better?*

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Note: *If for any test, average figures are needed, the same may be ignored and the data as given above to the applicant may be used.* ***(6 Marks)***

Answer

(a) (i) An assessee may, at any stage of a case relating to him, make an application in the prescribed form and manner to the Settlement Commission under section 245C.

"Case" means any proceeding for assessment which may be pending before an Assessing Officer on the date on which such application is made. A proceeding for assessment or reassessment or recomputation under section 147 shall be deemed to have commenced from the date on which a notice under section 148 is issued.

In this case, Mr. Rajneesh cannot approach the Settlement Commission merely due to his apprehension that assessment of earlier years may be reopened, since there is no case pending before an Assessing Officer.

Therefore, he has to wait for the Assessing Officer to issue notice under section 148. Thereafter, he can make an application to the Settlement Commission under section 245C, since there would be a "case pending" before the Assessing Officer on that date.

Another basic condition to be satisfied for making an application is that the additional amount of income-tax payable on the income disclosed in the application should exceed ₹ 10 lakh, and such tax and interest thereon which would have been paid had the income disclosed in the application been declared in the return of income should be paid on or before the date of making the application and proof of such payment should be attached with the application.

If the Settlement Commission is satisfied that Mr. Rajneesh has co-operated in the proceedings and made true and full disclosure of his income and the manner in which it has been derived, it may, subject to such conditions as it may think fit to impose, grant to Mr. Rajneesh -

(i) immunity from prosecution for any offence under the Income-tax Act, 1961, where the proceedings for such prosecution have been instituted on or after the date of receipt of application under section 245C; and

(ii) immunity from imposition of penalty under the Income-tax Act, 1961, either wholly or in part, with respect to the case covered by the settlement.

This is the benefit that may accrue to Mr. Rajneesh, if he approaches the Settlement Commission.

(ii) No revisionary order shall be made under section 263 after the expiry of two years from the end of the financial year in which the order sought to be revised was passed.

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The issue under consideration is whether the period of limitation for an order passed under section 263 has to be reckoned from the original order passed by the Assessing Officer under section 143(3) of the Income-tax Act, 1961 or from the order of reassessment passed under section 147, where the subject matter of revision is different from the subject matter of reassessment under section 147.

Where the subject matter of revision was not the same as the subject matter of reassessment, the period of limitation would commence from the date of original assessment and not from the date of reassessment.

In this case, the period of limitation as referred to in section 263 is with reference to the assessment in which the claim of the assessee as to deduction under section 36(1)(vii) and deduction in respect of foreign exchange rate difference was considered. These issues were not the subject matter of reassessment proceedings.

Accordingly, the period of limitation shall be reckoned with reference to the original assessment order and not from the date of the order of reassessment.

Therefore, in this case, the revision proceedings are barred by limitation since the original assessment order was made on 30.11.2015 and the revision should have been made by 31.3.2018. However, the revision order was passed only on 31st May, 2018 and hence, the same is barred by limitation.

Accordingly, the claim of the Foundation Bank Ltd. that the order passed by the Principal Commissioner under section 263 is barred by limitation is tenable in law.

Note: *The facts of the case are similar to the facts in CIT v. ICICI Bank Ltd. (2012) 343 ITR 74, wherein the above issue came up before the Bombay High Court. Similar issue also came up before the Bombay High Court in CIT v. Lark Chemicals Ltd (2014) 368 ITR 655. The Bombay High Court relied on the Apex Court decision in the case of CIT v. Alagendran Finance Ltd. (2007) 293 ITR 1. The above answer is based on the rationale of the Bombay High Court in the said case.*

(b) (i) The statement is false

In respect of returns furnished for A.Y.2017-18 or thereafter, processing of a return under section 143(1) is necessary even where a notice has been issued to the assessee under section 143(2).

(ii) The statement is true

Section 142A(2) provides that the Assessing Officer may make a reference to the Valuation Officer whether or not he is satisfied about the correctness or completeness of the accounts of the assessee. Thus, even without rejecting the books of accounts maintained by the assessee, the Assessing Officer may make reference to the Valuation Officer under section 142A.

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(iii) The statement is true

Where the direction for special audit is issued by the Assessing Officer, the expenses of, and incidental to, such special audit, shall be determined by the Principal Chief Commissioner or Chief Commissioner or Principal Commissioner or Commissioner in accordance with the prescribed guidelines. The expenses so determined shall be paid by the Central Government.

(iv) The statement is true

The definition of Tax Return Preparer includes only an individual who has been authorised to act as a Tax Return Preparer under the Scheme framed under section 139B.

(c) Since the search is conducted post 15.12.2016, and return is yet to be filed for the P.Y. 2017-18, the penalty would be as follows:

(1) **penalty@30%,** if undisclosed income is admitted during the course of search in the statement furnished under section 132(4), and the assessee explains the manner in which such income was derived, pays the tax, together with interest if any, in respect of the undisclosed income, and furnishes the return of income for the specified previous year declaring such undisclosed income on or before the specified date (i.e., the due date of filing return of income or the date on which the period specified in the notice issued under section 153A expires, as the case may be).

(2) **penalty@60%,** in any other case.

Therefore, even if Mr. Khemka has made a declaration under section 132(4), penalty@30% of undisclosed income of the specified previous year i.e., P.Y. 2017-18 would be attracted under section 271AAB.

(d) (i) For determining the POEM of a company, the important criteria is whether the company is engaged in active business outside India or not.

A company shall be said to be engaged in "**Active Business Outside India"** (ABOI) for POEM, if

- the passive income is not more than 50% of its total income; **and**
- less than 50% of its total assets are situated in India; **and**
- less than 50% of total number of employees are situated in India or are resident in India; **and**
- the payroll expenses incurred on such employees is less than 50% of its total payroll expenditure.

John Butler Tex. Inc. shall be regarded as a company engaged in active business outside India for P.Y. 2017-18 for POEM purpose only if it satisfies all the four conditions cumulatively.

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Condition 1: The passive income of John Butler Tex. Inc. should not be more than 50% of its total income

Total income of John Butler Tex. Inc. during the P.Y. 2017-18 is ₹ 100 crores [(₹ 15 crores + ₹ 30 crores) + (₹ 42 crores + ₹ 13 crores)]

Passive income is the aggregate of, -

(i) income from the transactions where both the purchase and sale of goods is from/to its associated enterprises; and

(ii) income by way of royalty, dividend, capital gains, interest or rental income;

Passive Income of John Butler Tex. Inc. is ₹ 43 crores, being income from investment of ₹ 30 Crores in India and ₹ 13 crores in Sri Lanka.

Percentage of passive income to total income = ₹ 43 crore/ ₹ 100 crore x 100 = 43%

Since passive income of John Butler Tex. Inc. is 43% i.e., is not more than 50% of its total income, the first condition is satisfied.

Condition 2: John Butler Tex. Inc. should have less than 50% of its total assets situated in India

Value of total assets of John Butler Tex. Inc. during the P.Y. 2017-18 is ₹ 500 crores [₹ 160 crores, in India + ₹ 340 crores, in Sri Lanka].

Value of total assets of John Butler Tex. Inc. in India during the P.Y. 2017-18 is ₹ 160 crores.

Percentage of assets situated in India to total assets = ₹ 160 crores/₹ 500 crores x 100 = 32%

Since the value of assets of John Butler Tex. Inc. situated in India is less than 50% of its total assets, the second condition for ABOI test is satisfied.

Condition 3: Less than 50% of the total number of employees of John Butler Tex. Inc. should be situated in India or should be resident in India

Number of employees situated in India or are resident in India is 40

Total number of employees of John Butler Tex. Inc. is 100 [40 + 60]

Percentage of employees situated in India or are resident in India to total number of employees is 40/100 x 100 = 40%.

Since employees situated in India or are residents in India of John Butler Tex. Inc. are less than 50% of its total employees, the third condition for ABOI test is satisfied.

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Condition 4: The payroll expenses incurred on employees situated in India or residents in India should be less than 50% of its total payroll expenditure

Since the information pertaining to payroll expenditure of employees situated in India and situated outside India is not given in the question it is assumed that the condition pertaining to payroll expenditure is also satisfied by John Butler Tex. Inc.

Thus, since the John Butler Tex. Inc. has satisfied all the four conditions, the company would be said to be engaged in "active business outside India".

Note *– Since the information pertaining to payroll expenditure of employees situated in India and situated outside India is not given in the question it is also possible to assume that the condition pertaining to payroll expenditure is not satisfied by John Butler Tex. Inc.*

In such case, the company would not be said to be engaged in "active business outside India", since John Butler Tex. Inc. has not satisfied one of condition i.e., payroll expenditure out of the specified four conditions.

(ii) Option 1: 30 more employees employed in India for the increased operations

In case John Butler Tex. Inc. employed 30 more employees in India, then Percentage of employees situated in India or are resident in India to total number of employees would be 70/130 x 100 = 53.85%.

In such a case, one of the four conditions would not be satisfied and therefore, John Butler Tex. Inc. would not be considered to be engaged in ABOI.

It may be noted that place of effective management of a company passing the ABOI test would be presumed to be outside India, if majority of the board meetings are held outside India. Consequently, the global income of the company would not be subject to tax in India. However, such a presumption cannot be made if the company does not fulfil any of the four conditions for ABOI.

Option 2: Increased operations outsourced to external agency which will get the work done by engaging 15 employees in India

For the purpose of ABOI, employees shall include persons, who though not employed directly by the company, perform tasks similar to those performed by the employees.

Thus, 15 employees engaged by external agency have also to be included while determining the percentage of employees situated in India or are resident in India to the total number of employees.

In such a case, the percentage of employees situated in India or are resident in India to total number of employees would be 55/115 x 100 = 47.83%

In such a case, John Butler would continue to satisfy the four conditions for ABOI. Thus, it would be better to outsource the increased operation to an external agency.

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Question 6

(a) *Mr. B proposes to purchase for his business, certain raw materials from Mr. S. In view of the scarcity of the products, S insists on cash payments for the purchases, to which B agrees. On 27-3-2018, the purchases are effected through a cash invoice for ₹ 3,20,000.*

In respect of the above transactions, will there be any detrimental effect in the hands of B and S under the provisions of the Income-tax Act, 1961? Explain briefly.

Will your answer be different, if the cash purchases are effected by the buyer B on two different dates for different raw materials for ₹ 1,80,000 and ₹ 1,40,000 respectively?

(5 Marks)

(b) *Mr. Sarthak a software engineer wants to commence a business in manufacture of solar powered car. He provides the following information:*

(i) The project cost is estimated at ₹ 5 crores.

(ii) He has a residential house in Surat since 2010 which could be sold for ₹ 3 crores.

(iii) And the balance ₹ 2 crores could be financed through bank borrowings at a cost of 13% per annum.

(iv) He has another option viz. his friend Miss Juhi who is willing to contribute ₹ 2 crores and become a co-promoter.

The indexed cost of acquisition of the residential house (Computed) is ₹ 70 lakhs.

Mr. Sarthak seeks your guidance on the project finance taking into account any tax incentives available under Income Tax Law besides the funding of project through bank finance or accepting Miss Juhi as Co-promoter.

You are requested to advise Mr. Sarthak, on Income tax aspects to avail tax benefits within the four corners of law. ***(9 Marks)***

(c) *T Inc., a non-resident entity incorporated in Mauritius, has permanent Establishment (PE) in India. The PE filed its return of income for the assessment year 2018-19 disclosing income of ₹ 100 lakhs and paid tax at the rate applicable to the domestic company i.e. 30% plus applicable surcharge and cess on the basis of paragraph 2 of Article 24 of Double Tax Avoidance Agreement (non-discrimination) between India and Mauritius, which reads as follows:*

"The taxation on PE which is an enterprise of a contracting state has in the other contracting state shall not be less favourably levied in that other state than the taxation levied on enterprise of that other state carrying on the same activities in the same circumstances."

However, the Assessing Officer computed the Tax on the PE at the rate applicable to a foreign company (40%). Is the action of AO in accordance with law? ***(3 Marks)***

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(d) Alpha Inc., a non-resident company has an IT enabled business process outsourcing Unit in India (BPO) and it provides certain outsourcing services to a resident Indian entity.

Discuss, the tax implications, in the hand of Alpha Inc. due to presence of BPO unit in India. ***(3 Marks)***

Answer

(a) (1) Where purchases are effected through cash invoice of ₹ 3,20,000

(i) In the hands of Mr. B

Since Mr. B is making cash payment of ₹ 3,20,000 for purchase of raw materials from Mr. S for his business, disallowance under section 40A(3) would be attracted, since the payment otherwise than by way of account payee cheque or bank draft or use of ECS through a bank account to a person in a day exceeds ₹ 10,000. Accordingly, ₹ 3,20,000 would not be allowable as deduction while computing his business income.

(ii) In the hands of Mr. S

Section 269ST prohibits, *inter alia*, receipt of an amount of ₹ 2 lakh or more in aggregate from a person in a day otherwise than by way of account payee cheque or account payee bank draft or use of ECS through a bank account. If any person receives any sum in contravention of the provisions of section 269ST, he shall be liable to pay penalty under section 271DA of a sum equal to the amount of such receipt.

In this case, since S has received ₹ 3,20,000 by way of cash from Mr. B on 27.3.2018, he has violated the provisions of section 269ST, and hence, is liable to pay penalty of ₹ 3,20,000 under section 271DA.

(2) Where cash purchases of ₹ 1,80,000 and ₹ 1,40,000 are effected in respect of different raw materials on two different dates

(i) <u>In the hands of Mr. B</u>

Even if cash payment of ₹ 1,80,000 and ₹ 1,40,000 are made by Mr. B on two different dates for different raw materials, disallowance under section 40A(3) would be attracted, since the payment in cash in a day to Mr. S exceeds ₹ 10,000.

(ii) <u>In the hands of Mr. S</u>

If S receives cash of ₹ 1,80,000 and ₹ 1,40,000 on two different dates, for purchase of different raw materials, there would be no violation of section 269ST since receipt on a day is less than ₹ 2 lakh and the receipts are not in respect of the same transaction but for purchase of different raw materials. Hence, provision of section 271DA shall not be attracted.

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(b) Under section 80-IAC, where the gross total income of an eligible start-up includes any profits and gains derived from eligible business, a deduction of 100% of the profits and gains derived from such business would be available for any 3 consecutive assessment years out of 7 consecutive assessment years, beginning from the previous year in which eligible start-up is incorporated.

Under section 54GB, the capital gains arising to an individual from transfer of his long-term capital asset, being a residential house, would be exempt if invests the net consideration in a company which is an eligible start-up carrying on eligible business under section 80-IAC.

In this case, the business of manufacture of a solar powered car falls within the meaning of eligible business, since it is driven by technology.

In order to avail the benefit of deduction under section 54GB, Mr. Sarthak must invest the net consideration of ₹ 3 crores on transfer of long-term capital asset, being his residential house in Surat, in an eligible start up, by setting up a new company before 1.4.2019 and subscribing to the equity shares of the company.

The start-up company formed to carry on the business of manufacture of solar powered car would be an eligible start-up which is technology driven, if it obtains a certificate of eligible business from IMBC and its turnover does not exceed ₹ 25 crores in any of the previous years upto P.Y. 2020-21.

Mr. Sarthak should subscribe to more than 50% of the share capital of the company on or before the due date of filing of return of income under section 139(1) and the company should purchase new plant and machinery within one year from the date of subscription in equity shares by him.

If these conditions are fulfilled, the long-term capital gains of ₹ 2,30,00,000 [₹ 3,00,00,000 – ₹ 70,00,000] arising to Mr. Sarthak would not be chargeable to tax, since the entire net consideration of ₹ 3 crores has been utilised to subscribe to the shares of a company, being an eligible start up.

Furthermore, in any three consecutive assessment years out of seven consecutive assessment years, beginning from the previous year in which eligible start-up is incorporated, the company would be eligible to claim deduction of 100% of the profits and gains of business.

If the balance ₹ 2 crores is funded through bank borrowings, the interest payable would qualify for deduction under section 36 while computing the business income of the company, which would be beneficial in those years in which the company has not availed 100% deduction under section 80-IAC.

On the other hand, if ₹ 2 crores is funded through subscription of shares by Miss Juhi, who would be a co-promoter, there would be sharing of both the risks and rewards with Miss Juhi. Since her shareholding would be only 40%, this arrangement will also not affect Mr. Sarthak's claim for deduction under section 54GB.

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(c) Under section 90(2), where the Central Government has entered into an agreement for avoidance of double taxation with the Government of any country outside India or specified territory outside India, as the case may be, then, in relation to the assessee to whom such agreement applies, the provisions of the Income-tax Act, 1961 shall apply to the extent they are more beneficial to the assessee.

Thus, in view of paragraph 2 of the Article 24 (Non-discrimination of the Double Taxation Avoidance Agreement (DTAA), it appears that the PE of T Inc. a non-resident entity, incorporated in Mauritius, is liable to tax in India at the rate applicable to domestic company (30%), which is lower than the rate of tax applicable to a foreign company (40%).

However, *Explanation* 1 to section 90 clarifies that the charge of tax in respect of a foreign company at a rate higher than the rate at which a domestic company is chargeable, shall not be regarded as less favourable charge or levy of tax in respect of such foreign company.

Therefore, in view of this *Explanation*, the action of the Assessing Officer in levying tax@40% on the PE of T Inc. a non-resident entity, incorporated in Mauritius is in accordance with law.

(d) The CBDT had, *vide Circular No.5/2004 dated 28.9.2004,* clarified that the non-resident entity or the foreign company will be liable to tax in India only if the IT enabled BPO unit in India constitutes its Permanent Establishment.

In the present case, since Alpha Inc. has an IT enabled Business Process Outsourcing unit in India (BPO) which provides certain outsourcing services to a resident Indian entity, such BPO would be considered as PE of Alpha Inc., as it carries on business in India through the BPO Unit.

In such a case, the profits of Alpha Inc., attributable to the business activities carried out in India by the Permanent Establishment would become taxable in India.

Profits are to be attributed to the Permanent Establishment as if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a Permanent Establishment.

In determining the profits of a Permanent Establishment, there shall be allowed as deduction, expenses which are incurred for the purposes of the Permanent Establishment including executive and general administrative expenses so incurred, whether in the State in which the Permanent Establishment is situated or elsewhere.

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