c. the combined net profit is then split amongst the enterprises in proportion to their relative contributions, as evaluated under (*b*) (*supra*);

d. the profit thus apportioned to the assessee is taken into account to arrive at an arm's length price in relation to the international transaction :

However, the combined net profit referred to in (*a*) *supra* may, in the first instance, be partially allocated to each enterprise so as to provide it with a basic return appropriate for the type of international transaction in which it is engaged, with reference to market returns achieved for similar types of transactions by independent enterprises, and thereafter, the residual net profit remaining after such allocation may be split amongst the enterprises in proportion to their relative contribution in the manner specified under (*b*) and (*c*) *supra*, and in such a case the aggregate of the net profit allocated to the enterprise in the first instance together with the residual net profit apportioned to that enterprise on the basis of its relative contribution shall be taken to be the net profit arising to that enterprise from the international transaction.

This method may be applicable in cases where transactions involved transfer of unique, intangible or any multiple interrelated international transactions, which cannot be evaluated separately for determining the ALP of any one transaction.

The profit split method first identifies the profit to be split for the associated enterprise from the controlled transactions in which the associated enterprises are engaged. It then splits those profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length price. The combined profit may be the total profit from the transactions or a residual profit intended to represent the profit that cannot readily be assigned to one of the parties, such as the profit arising from high value, sometimes unique, intangibles.

The contribution of each enterprise is based upon a functional analysis and valued to the extent possible by any available reliable external market data. The functional analysis is an analysis of the functions performed (taking into account assets used and risks assumed) by each enterprise. The external market criteria may include, for example, profit split percentages or returns, observed among independent enterprises with comparable functions.

509.1-5 ***TRANSACTIONAL NET MARGIN METHOD (TNMM)*** - According to transactional net margin method—

a. the net profit margin realised by the enterprise from an international transaction entered into with an associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base;

b. the net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base;

c. the net profit margin referred to in (*b*) (*supra*) arising in comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market;

d. the net profit margin realised by the enterprise and referred to in (*a*) (*supra*) is established to be the same as the net profit margin referred to in (*c*) (*supra*);

e. the net profit margin thus established is then taken into account to arrive at an arm's length price in relation to the international transaction.

The TNMM requires establishing comparability at a broad functional level. It requires comparison between net margins derived from the operation of the uncontrolled parties and net margin derived by an associated enterprise on similar operation.

Under this method, the net profit margin realized by an associated enterprise from an international transaction is computed in relation to a particular factor such as costs incurred, sales, assets utilized, etc. The net profit margin realized by an associated enterprise is compared with net profit margin

of the uncontrolled transactions to arrive at the ALP. The TNMM is similar to RPM and CPM to the extent that it involves comparison of margin earned in a controlled situation with margins earned from comparable uncontrolled situation. The only difference is that in the RPM and CPM methods, comparison is of margins of gross profits whereas in TNMM the comparison is of margins of net profit - ***Aztec Software & Technology Services Ltd.*** v. ***CIT*** [2007] 162 Taxman 128 (Bangalore).

509.2 ***Comparability of transaction*** - The comparability of one transaction with another shall be judged with reference to the following, namely—

a. the specific characteristics of the property or services transferred in either transaction;

b. the functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions;

c. the contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions;

d. conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail.

509.2-1 ***WHEN TWO TRANSACTIONS ARE DEEMED TO BE COMPARABLE*** - An uncontrolled transaction shall be comparable to an international transactions, if—

a. none of the differences (if any) between the transactions being compared, or between the enterprises entering into such transaction, are likely to materially affect the price or cost charged or paid in, or the profit arising from, such transactions in the open market; or

b. reasonably accurate adjustments can be made to eliminate the material effects of such differences.

The data to be used in analysing the comparability of an uncontrolled transaction with an international transaction shall be the data relating to the financial year in which the international transaction has been entered into. However, the data relating to a period (not being more than two years prior to such financial year) may also be considered if such data reveals facts which could have an influence on the determination of transfer prices in relation to the transactions being compared.

509.3 ***Most appropriate method*** - According to section 92C(1), the arm's length price shall be determined having regard to the most appropriate method. The most appropriate method shall be the method which is best suited to the facts and circumstances of each particular transaction, and which provides the most reliable measure of an arm's length price in relation to an international transaction.

The most appropriate method shall be selected having regard to the following, namely :

i. the nature and class of the international transaction;

ii. the class or classes of associated enterprises entering into the transaction and the functions performed by them taking into consideration assets employed or risk assumed;

iii. the availability, coverage and reliability of data necessary for application of the method;

iv. the degree of comparability existing between the international transaction and the uncontrolled transaction and between the enterprises entering into such transactions;

v. the extent to which reliable and accurate adjustments can be made to account for differences, if any, between the transactions being compared and the enterprises entering into such transactions;

vi. the nature, extent and reliability of assumptions required to be made in application of a method.

In a case where the factors referred to above indicate more than one method as the most appropriate method, the method providing a result consistent with the result obtainable by application of a method other than such methods may be taken as the most appropriate method.

However, in a given situation, and to the extent possible, the comparable uncontrolled price method, or the resale price method or the cost *plus* method shall be considered to be more appropriate than the profit split method or the transactional net margin method.

■ *Mean of arm's length price* - With a view to allow a degree of flexibility in adopting an arm's length price, it is provided that where the most appropriate method results in more than one price, a price which differs from the arithmetical mean by an amount not exceeding 5 per cent of such mean may be taken to be the arm's length price at the option of the assessee.

509.4 *Determination of arm's length price by Assessing Officer in certain cases [Sec. 92C(3)]* - The Assessing Officer may determine the arm's length price, if the following conditions are satisfied :

1. There is a proceeding for assessment of income.

2. The Assessing Officer has material or information or document in his possession.

3. On the basis of such material or information or document, the Assessing Officer is of the 'opinion' that the—

a. arm's length price charged or paid in an international transaction has not been determined in accordance with sub-section (1) or (2) of section 92C; or

b. assessee has not kept the prescribed information and document relating to an international transaction; or

c. information or data used for consulting the arm's length price is not reliable or correct; or

d. assessee has failed to furnish, within the time specified any information or document which was required to be furnished by the Assessing Officer.

On satisfaction of the aforesaid conditions, the Assessing Officer may proceed to determine the arm's length price.

509.4-1 *WHEN ACTION SHOULD BE TAKEN BY THE ASSESSING OFFICER* - It should be made clear to the concerned Assessing Officers that where an international transaction has been put to a scrutiny, the Assessing Officer can have recourse to sub-section (3) of section 92C only under the circumstances enumerated in clauses (*a*) to (*d*) of that sub-section and in the event of material information or document in his possession on the basis of which an opinion can be formed that any such circumstance exists. In all other cases, the value of the international transaction should be accepted without further scrutiny—Circular No. 12/2001, dated August 23, 2001.

509.4-2 *MATERIAL OR INFORMATION OR DOCUMENT IN POSSESSION* - The information must be something more than mere rumour or gossip or hunch. The opinion must be based on the material which is available and it should not be formed on the basis of extraneous or irrelevant material. The formation of opinion shall have rational connection and bearing to the reasons for such opinion. The formation of opinion should be based on active application of mind and be *bona fide* and not be accentuated by *mala fide,* bias or based on extraneous or irrelevant material. The belief must be *bona fide* and cogently supported—*Prabhubhai Vastabhai Patel* v. *R.P. Meena* [1997] 226 ITR 781 (Guj.). The words 'information in his possession' should be construed as some valid, definite information in possession and not any imaginary or invalid information. The information should be credible and if there is some such information, the court cannot go into the sufficiency of the information—*Kusum Lata* v. *CIT* [1989] 180 ITR 365 (Raj.).

The expression 'material or information or document' should be construed as some valid and definite material, information or document and not any imaginary or invalid material, information or document. The material, information or document should not be vague and far fetched.

509.4-3 *OPPORTUNITY OF BEING HEARD* - According to proviso to section 92C(3) an opportunity shall be given by the Assessing Officer by serving a notice calling upon the assessee to show cause, why the arm's length price should not be so determined on the basis of material or information or document in the possession of the Assessing Officer.

In other words, an assessee should be given an opportunity of being heard and a right to question the correctness or the relevancy of the materials on the basis of which the Assessing Officer proposes to make the best judgment assessment—*Dhanlakshmi Pictures* v. *CIT* [1983] 144 ITR 452 (Mad.), *T.C.N. Menon* v. *ITO* [1974] 96 ITR 148 (Ker.), *Narayan Chandra Baidya* v. *CIT* [1951] 20 ITR 287 (Cal.), *Gopal Stores* v. *CIT* [1995] 215 ITR 265 (Gauhati), *CIT* v. *Kolbeong Co. Ltd.* [1983] 143 ITR 512 (Cal.), *Miri Mal Mahajan* v. *CIT* [1974] 95 ITR 186 (Punj. & Har.).

509.4-4 *SERVICE OF NOTICE* - The issue and service of a notice is not a mere procedural formality. The assessment would be invalidated on account of failure to provide a reasonable opportunity to the assessee of being heard [*see Addl. CIT* v. *Radhey Shyam Jagdish Prasad* [1979] 117 ITR 186 (All.); *S. Velu Palandara* v. *CTO* [1972] 83 ITR 683 (Mad.); *Sadaram Puranchand* v. *CIT* [1931] 5 ITC 459 (Cal.), *Miri Mal Mahajan* v. *CIT* [1974] 95 ITR 186 (Punj. & Har.)].

509.4-5 *DISCLOSURE TO ASSESSEE* - The Assessing Officer has to provide an opportunity to the assessee to show cause as to why the arm's length price should not be determined on the basis of material or information or documents in the Assessing Officer's possession. It is only when the information or document on the basis of which show-cause notice is issued is made available to the assessee that the assessee will be able to rightfully represent himself and be able to show cause as to why the arm's length price should not be so determined as proposed by the Assessing Officer [*see Rampyari Devi Saraogi* v. *CIT* [1968] 67 ITR 84 (SC), *Russell Properties (P.) Ltd.* v. *A. Chowdhury, CIT* [1977] 109 ITR 229 (Cal.)].

509.4-6 *COMPUTATION BY ASSESSING OFFICER NOT MANDATORY* - Section 92C(3) provides that if the Assessing Officer is, on the basis of material or information or document in his possession, of the opinion that the price charged or paid in an international transaction has not been determined in accordance with provisions of section, he may proceed to determine the arm's length price.

As the word 'may' has been used, it can be said that there is no stringent rule that in every case where the price charged/paid is not in accordance with section 92C(1) and (2), the arm's length price must be determined under section 92C(3) by the Assessing Officer.

509.4-7 *BURDEN OF PROOF* - A dispassionate study of provisions of various countries on burden of proof, would show the following fundamental features:

1. That the burden to establish that international transaction is carried at ALP, is on the taxpayer who is to disclose all the relevant information and documents relating to prices charged and profit earned with related and unrelated customer.

2. If the Assessing Officer has determined an ALP, other than the price declared by the assessee, the Assessing Officer has to prove that the price determined by him is reliable and reasonable and confirms the statutory requirement unless the case is covered by situation No. (*3*) below.

3. In case of failure on the part of the taxpayer to comply with the statutory provisions, the tax authorities would have to determine the ALP. In such a situation, burden of proof on tax authorities is much reduced - ***Aztec Software & Technology Services Ltd.*** v. ***CIT*** [2007] 162 Taxman 133 (Bang.).

509.5 ***Determination of total income after computing arm's length price [Sec. 92C(4)]*** - The Assessing Officer may compute the total income of the assessee having regard to arm's length price determined under section 92C(3). However, the Assessing Officer shall not make any adjustment to the arm's length price determined by the taxpayer, if such price is up to 5 per cent less or up to 5 per cent more than the price determined by the Assessing Officer. In such cases, the price declared by the taxpayer may be accepted—Circular No. 12/2001, dated August 23, 2001.

The Assessing Officer is empowered to recompute the total income of the assessee having regard to the arm's length price. If the total income is enhanced, no deduction under sections 10A, 10AA†, 10B, or under Chapter VIA shall be allowed in respect of the increased quantum of income.

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† Section 10AA has been inserted with effect from the assessment year 2007-08.

■ *Speaking order* - The Assessing Officer is required to provide the assessee with a copy of reasons supporting the inference drawn while computing the arm's length price for the transaction - *see Ganga Prasad Sharma* v. *CIT*[1981] 132 ITR 87 (MP), *Anand Rice & Oil Mills* v. *CIT*[1977] 108 ITR 372 (Cal.), *Baidya Nath Sharma* v. *CWT*[1983] 140 ITR 801 (Gauhati).

509.6 *Income chargeable under the Act should not decrease on applying arm's length price [Sec. 92(3) and second proviso to sec. 92C(4)]* - The following two provisions should be noted—

1. The provisions of transfer pricing shall not be applicable in a case where the application of arm's length price results in a downward revision in the income chargeable to tax in India computed on the basis of entries made in the books of account of the previous year in which the international transaction was entered.

2. According to the second proviso to section 92C(4), total income of the recipient associated enterprise will not be recomputed if (*a*) total income of payer (associated enterprise) is recomputed by the Assessing Officer on determination of arm's length price, [*i.e.*, upon determination of arm's length price (which is less than contracted price of the international transaction), the Assessing Officer (of payer associate enterprise) increases the taxable income and reduces the allowable expenditure], and (*b*) tax has been deducted or deductible at source by the payer enterprise.

In other words, this proviso provides that while on determination of arm's length price (if arm's length price is less than the contracted price), the income of the payer enterprise will increase on account of decrease in the amount of allowable expenditure but the income of the recipient enterprise cannot be accordingly reduced by such amount of contracted price which is in excess of the amount of arm's length price.

509.6-P1 *X Ltd., a company incorporated in US, sells laser printer cartridge to its 100 per cent Indian subsidiary A Ltd. @ $50 per cartridge. X Ltd. also sells its laser printer cartridge to another company Y Ltd. in India @ $80 per piece. Total income of A Ltd. for the assessment year 2009-10 is Rs.12,00,000 after making payment for 100 cartridges @ $50 (1$=Rs. 49). A Ltd. has deducted tax at source while making payments to X Ltd. In this case, sale to unrelated party Y Ltd. is @ $80. Compute the arm's length price and taxable income of X Ltd. and A Ltd. The rate of one dollar may be assumed to be equivalent to Rs. 49 in all transactions for the sake of simplicity.*

SOLUTION : *Arm's length price* - Arm's length price of laser printer cartridge, which is sold to A Ltd. will be $80 per cartridge by comparable uncontrolled price method.

Income of A Ltd. - It will be computed as under—

	Rs.
Income as per books of account	12,00,000
Add: Amount charged by X Ltd. [$50 × 100 × Rs. 49]	(+) 2,45,000
Less: Arm's length price [$80 × 100 × 49]	(-) 3,92,000
Income (after applying arm's length price)	10,53,000

By virtue of section 92(3), one cannot reduce taxable income by applying arm's length price. Therefore, income of A Ltd. will be Rs. 12,00,000.

Income of X Ltd. - The CBDT has given the following clarification by Circular No. 23, dated July 23, 1969—

If the transactions are actually on a principal-to-principal basis and are at arm's length and the subsidiary company functions and carries on business on its own, instead of functioning as an agent of the parent company, the mere fact that the Indian company is a subsidiary of the non-resident company will not be considered a valid ground for invoking section 9 for assessing the non-resident.

If the aforesaid conditions are satisfied, then X Ltd. is not chargeable to tax in India.

Conversely, if the aforesaid conditions are not satisfied, X Ltd. will be chargeable to tax in India in respect of income which arises on sale of goods to A Ltd. However, the adoptation of arm's length price by the Assessing Officer will not affect the computation of taxable income of X Ltd. [as per second proviso to section 92C(4) when tax is deducted/deductible, the income of recipient enterprise will not be recomputed if arm's length price is adopted in the case of payer-enterprise].

509.6-P2 *Suppose in problem 509.6-P1, X Ltd. sells ink cartridge @ $ 45 to Y Ltd., an unrelated company, in India.*

SOLUTION : *Arm's length price* - It will be $ 45 per cartridge.

Income of A Ltd. - It will be Rs. 12,24,500 [*i.e.*, Rs. 12,00,000 + ($ 50 × 100 × Rs. 49) – ($ 45 × 100 × 49)].

Income of X Ltd. - See the answer given in problem 509.6-P1.

509.6-P3 *A Ltd. is an Indian company. It has a manufacturing unit in Andhra Pradesh. It is a subsidiary company of X Ltd., a US company. X Ltd. gets royalty from A Ltd. on supply of technical information which is used by A Ltd. for manufacturing goods in its unit in Andhra Pradesh. For similar transfer of technical information to any unrelated entity X Ltd. charges $ 8,000 per year. However, from A Ltd. it charges (a) $ 11,000 or $ 6,000 per year which is subject to tax deduction by A Ltd. Exchange rate is Rs. 49 per US dollar. Income of A Ltd. for the assessment year 2008-09 before deducting payment for technical information to A Ltd. is Rs. 76,00,000. Find out the income of X Ltd. and A Ltd.*

SOLUTION :

	Situation (a) Rs.	Situation (b) Rs.
Arm's length price ($ 8000 × 49) (*a*)	3,92,000	3,92,000
Income of A Ltd.		
Income	76,00,000	76,00,000
Less: Payment to X Ltd. at recorded price [$11,000 × 49, $ 6,000 × 49] (*b*)	5,39,000	2,94,000
Income as per books of account (*c*)	70,61,000	73,06,000
Add: Recorded price	(+) 5,39,000	(+) 2,94,000
Less: Arm's length price [*i.e.*, (*a*)]	(-) 3,92,000	(-) 3,92,000
Total (*d*)	72,08,000	72,08,000
Taxable income [(*d*), but it cannot be lower than (*c*), as per section 92(3)]	72,08,000	73,06,000
Income of X Ltd.		
Actual payment [*i.e.*, (*b*)] as tax has been deducted by the payer [see Note]	5,39,000	2,94,000

As per second proviso to section 92C(4), where income of payer has been recomputed by applying the arm's length price, then the income of payee associate enterprise shall not be recomputed if tax has been deducted or is deductible on such payment. Therefore, income of X Ltd. shall not be reduced in situation (*1*).

509.6-P4 *A Ltd., an Indian company, sells computer monitor to its 100 per cent subsidiary X Ltd. in United States @ $ 50 per piece. X Ltd. also sells its computer monitor to another company Y Ltd. in United States @ $ 80 per piece. Total income of A Ltd. for the assessment year 2009-10 is Rs. 12,00,000 which includes sales made for 100 computer monitor @ $50 to X Ltd. Compute the arm's length price and taxable income of A Ltd. The rate of one dollar may be assumed to be equivalent to Rs. 49 for the sake of simplicity.*

	Rs.
Arm's length price ($ 80 × 100 × Rs. 49)	3,92,000
Income of A Ltd.	
Income as per books of account	12,00,000
Less : Sale consideration 100 monitor sold to X Ltd. (recorded price)	(-) 2,45,000
Add : Sale consideration at arm's length price	(+) 3,92,000
Taxable income	13,47,000
Income of X Ltd.	

As no income is deemed to accrue or arise in India, nothing is taxable in the hands of X Ltd.

Reference to transfer pricing officer [Sec. 92CA]†

510. The Assessing Officer may refer the computation of arm's length price under section 92C to the Transfer Pricing Officer (TPO) if he considers it necessary and expedient and an approval of the Commissioner has been obtained. "Transfer Pricing Officer" means a Joint Commissioner or Deputy Commissioner or Assistant Commissioner, authorised by the Board to perform all or any of the

†Section 40A(2) cannot override the provisions of section 92CA.

functions of an Assessing Officer specified in sections 92C and 92D in respect of any person or class of persons.

510.1 ***Necessary or expedient - Meaning of*** - According to the *Shorter Oxford English Dictionary,* the word "necessary" means indispensable, requisite, needful. Similarly, the word "expedient" means advantageous; fit, proper, or suitable to the circumstances of the case; those which help forward or conduces to an end; a means to an end.....Therefore, where Assessing Officer thinks it indispensable and advantageous to help forward in the case, then he may refer the computation of the arm's length price to the Transfer Pricing Officer. It should be noted that here in section 92CA the words "necessary or expedient" has not been qualified with a requirement unlike section 143(2) where it has been qualified. Section 143(2) provides that where Assessing Officer considers it necessary or expedient to ensure that the assessee has not understated the income or has not computed excessive loss..... In section 143(2), the words "necessary or expedient" has been qualified with a responsibility of ensuring that assessee has not understated his income. However, in section 92CA there is no such overriding requirements and hence it has a more broader scope.

It cannot be held that avoidance of tax is a condition precedent for invoking the provisions of section 92C/92CA. There is no requirement of establishment of 'tax evasion' before initiation of proceedings for determination of ALP — ***Aztec Software & Technology Services Ltd.*** v. ***CIT*** [2007] 162 Taxman 121 (Bang.).

510.2 ***Opportunity of hearing to assessee*** - Transfer Pricing Officer shall serve a notice to the assessee requiring him to produce (or cause to be produced) on a specified date any evidence which the assessee may rely in support of the computation made by him of the arm's length price in relation to the international transaction. However, the Assessing Officer referring the case to the Transfer Pricing Officer is not required to provide any reasons or basis for referring the case to the assessee.

510.3 ***Passing of the order*** - After hearing the assessee, the evidence produced by him and after considering the evidence as the Transfer Pricing Officer may require on any specified points and after taking into account all relevant materials which he has gathered, the Transfer Pricing Officer shall by order in writing determine the arm's length price in relation to the international transaction in accordance with provisions of section 92C(3) and send a copy of his order to the Assessing Officer and to the assessee.

■ From June 1, 2007, an order under section 92CA(3) by a Transfer Pricing Officer for determination of arm's length price of international transactions shall be made at least 2 months before the new period of limitation referred to in section 153 or 153B, for making the order of assessment or reassessment or recomputation, or fresh assessment expires [for new time-limit—*see* para 370]. This provision shall also be applicable in cases where a reference was made to the Transfer Pricing Officer before June 1, 2007 for determining arm's length price of an international transaction but an order has not been passed by him before the said date.

510.4 ***Computation of income by Assessing Officer*** - On receipt of the order, the Assessing Officer shall proceed to compute the total income of the assessee under section 92C(3) having regard to the arm's length price determined by the Transfer Pricing Officer.The use of the words 'having regard to' denotes that it is not incumbent upon the Assessing Officer to compute the arm's length price as per the computation made by the Transfer Pricing Officer for each and every international transactions—*see Juggilal Kamlapat Bankers* v. *WTO* [1984] 145 ITR 485 (SC).

From June 1, 2007, the above provision has been amended so as to provide that, on receipt of the order of the Transfer Pricing Officer, the Assessing Officer shall proceed to compute the total income of the assessee in conformity with the arm's length price determined by the Transfer Pricing Officer.

510.5 ***Mistakes apparent from records*** - Transfer Pricing Officer may amend any order passed by him with a view to rectify any mistake apparent from the record and provisions of section 154 shall apply accordingly. Thereafter Transfer Pricing Officer shall send the copy of such order to the Assessing Officer and on the basis of such order the Assessing Officer shall amend his order accordingly.

Action can be taken with a view to rectifying any mistake apparent from the record. It does not enable an order to be reversed by revision or by review, but permits only some error which is apparent on the face of the record to be corrected. Where an error is far from self-evident, it ceases to be an apparent error—*CIT* v. *M.M.T.C. Ltd.* [2000] 112 Taxman 647 (Delhi).

510.6 ***Powers under section 131 or 133*** - The Transfer Pricing Officer may for the purpose of determining the arm's length price under section 92CA exercise all or any of the powers specified in clauses (*a*) to (*d*) of section 131(1) or section 133(6).

Maintenance of books of account [Sec. 92D]

511. Every person who has entered into an international transaction shall keep and maintain the following information and documents, namely—

a. a description of the ownership structure of the assessee enterprise with details of shares or other ownership interest held by other enterprises;

b. a profile of the multinational group of which the assessee enterprise is a part along with the name, address, legal status and country of tax residence of each of the enterprises comprised in the group with whom international transactions have been entered into by the assessee, and ownership linkages among them;

c. a broad description of the business of the assessee and the industry in which the assessee operates, and of the business of the associated enterprises with whom the assessee has transacted;

d. the nature and terms (including prices) of international transactions entered into with each associated enterprise, details of property transferred or services provided and the quantum and the value of each such transaction or class of such transaction;

e. a description of the functions performed, risks assumed and assets employed or to be employed by the assessee and by the associated enterprises involved in the international transaction;

f. a record of the economic and market analyses, forecasts, budgets or any other financial estimates prepared by the assessee for the business as a whole and for each division or product separately, which may have a bearing on the international transactions entered into by the assessee;

g. a record of uncontrolled transactions taken into account for analysing their comparability with the international transactions entered into, including a record of the nature, terms and conditions relating to any uncontrolled transaction with third parties which may be of relevance to the pricing of the international transactions;

h. a record of the analysis performed to evaluate comparability of uncontrolled transactions with the relevant international transaction;

i. a description of the methods considered for determining the arm's length price in relation to each international transaction or class of transaction, the method selected as the most appropriate method along with explanations as to why such method was so selected, and how such method was applied in each case;

j. a record of the actual working carried out for determining the arm's length price, including details of the comparable data and financial information used in applying the most appropriate method, and adjustments, if any, which were made to account for differences between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions;

k. the assumptions, policies and price negotiations, if any, which have critically affected the determination of the arm's length price;

l. details of the adjustments, if any, made to transfer prices to align them with arm's length prices determined under these rules and consequent adjustment made to the total income for tax purposes;

m. any other information, data or document, including information or data relating to the associated enterprise, which may be relevant for determination of the arm's length price.

The information specified above should be available by the due date of submission of return of income. In a case where the aggregate value of international transactions entered into by the assessee does not exceed Rs.1 crore, the information and documents specified above may not be maintained.

However, such assessee shall be required to substantiate, on the basis of material available with him, that income arising from international transactions entered into by him has been computed in accordance with section 92.

511.1 ***Support by authentic documentation*** - The information specified above shall be supported by authentic documentation, which may include the following :

a. official publications, reports, studies and data bases from the Government of the country of residence of the associated enterprise or of any other country;

b. reports of market research studies carried out by recognized institutions;

c. price publications including stock exchange and commodity market quotations;

d. published accounts and financial statements relating to the business affairs of the associated enterprise;

e. agreements and contracts entered into with associated enterprises or with unrelated enterprises, in respect of transactions similar the international transactions;

f. letters and other correspondence documenting any terms negotiated between the assessee and the associated enterprise;

g. documents normally issued in connection with various transactions.

The information specified above should by available by the due date of submission of return of income.

511.2 ***Continuity of international transaction for more than a year*** - Where an international transaction continues to have effect over more than one previous year, fresh documentation need not be maintained separately in respect of each previous year, unless there is any significant change in the nature or terms of the international transaction in the assumption made or in any other factor and in case of such significant change, fresh documentation as may be necessary under paras 511 and 511.1 shall be maintained detailing the impact of the change on pricing of the international transaction.

511.3 ***Period for which information should be maintained*** - The information and documents specified in paras 511, 511.1 and 511.2 shall be kept and maintained for a period of 8 years from the end of the relevant assessment year.

511.4 ***Furnishing information about international transaction*** - The Assessing Officer or Commissioner (Appeals) may in the course of any proceeding under this Act require any person who has entered into an international transaction to furnish any information or document in respect thereof.

It may be noted that Assessing Officer or Commissioner (Appeals) can require the assessee to furnish information only during continuation of any proceeding under Income-tax Act at the relevant time.

The Assessing Officer may require information or documents regarding existing proceeding but no information about future proceeding could be asked to be furnished.

This provision cannot be regarded as permitting to make roving or unnecessary enquiry and obtaining information or documents which are unrelated to an existing pending proceeding merely in order to enable the Assessing Officer to decide whether or not to institute the proceedings.

Thus, (*a*) there should be a pending proceeding in existence, and (*b*) information sought to be furnished must be of a nature which is relevant and fruitful for such pending proceedings.

■ This information or document will have to be furnished within a period of 30 days from the date of receipt of notice in this regard. The Assessing Officer or the Commissioner (Appeals) may grant an extension of not more than 30 further days to furnish the said information or document.

Report from accountant

512. The report from an accountant which is required to be furnished under section 92E by every person who has entered into an international transaction during the previous year shall be in Form No. 3CEB and be verified in the manner indicated therein. It shall be furnished before the due date of submission of return of income.

CHAPTER THIRTY-TWO

Business restructuring

Restructuring business

515. The term 'business restructuring' is composed of two different words 'business' and 'restructuring'. The term business includes trade, commerce, manufacture, etc. The word 'restructuring' means rearranging the affairs. In this way, business restructuring refers to the process by which the business enterprises rearrange their affairs. In todays' highly dynamic business environment, there exists cut throat competitions amongst business enterprises. In order to occupy a dominating position in the long-run, the corporate enterprises have to continuously update their strategies *vis-a-vis* their competitors and also search areas of possible comparative advantage. This has resulted in large scale restructuring in the corporate world in recent times.

This chapter covers the following :

1. Amalgamation [*see* para 516]

2. Demerger [*see* para 517]

3. Conversion of sole proprietary business into company [*see* para 518]

4. Conversion of firm into company [*see* para 519]

5. Slump sale [*see* para 520]

6. Transfer of assets between holding and subsidiary companies [*see* para 521]

7. Amalgamation or demerger of co-operative banks (applicable from the assessment year 2008-09 onwards) [*see* para 522].

Amalgamation

516. Amalgamation is a blending of two or more existing undertakings into one undertaking. The shareholders of each blending company become substantially the shareholders in the company which is to carry on the business of blended undertakings. There may be amalgamation either by the transfer of two or more undertakings to a new company, or by the transfer of one or more undertakings to an existing company.

516.1 ***Meaning of "amalgamation" under the Income-tax Act [Sec. 2(1B)]*** - For the purpose of the Income-tax Act, amalgamation of companies means either merger of one or more companies with another company or the merger of two or more companies to form one company. The definition of amalgamation under section 2(*1B*) covers the following cases (subject to conditions mentioned in para 516.1-1)—

- Merger of A Ltd. with X Ltd. (A Ltd. goes out of existence).
- Merger of A Ltd. and B Ltd. with X Ltd. (A Ltd. and B Ltd. go out of existence).
- Merger of A Ltd. and B Ltd. into a newly incorporated company X Ltd. (A Ltd. and B Ltd. go out of existence).
- Merger of A Ltd., B Ltd. and C Ltd., into a newly incorporated company X Ltd. (A Ltd., B Ltd. and C Ltd. go out of existence).

In the aforesaid cases, A Ltd., B Ltd. and C Ltd. are amalgamating companies, while X Ltd. is an amalgamated company.

516.1-1 *CONDITIONS* - For a merger to qualify as an "amalgamation" for the purpose of the Income-tax Act, it has to satisfy the following conditions—

Condition 1	All the properties of the amalgamating company immediately before the amalgamation should become the property of the amalgamated company by virtue of the amalgamation
Condition 2	All liabilities of the amalgamating company immediately before the amalgamation should become the liabilities of the amalgamated company by virtue of the amalgamation
Condition 3	Shareholders holding not less than three-fourths (in value) of the shares in the amalgamating company (other than shares already held by the amalgamated company or by its nominee) should become shareholders of the amalgamated company by virtue of the amalgamation.

One should also keep in view the following—

1. To illustrate, the aforesaid condition (3), where A Ltd. merges with X Ltd., in a scheme of amalgamation, and immediately before the amalgamation, X Ltd. held 20 per cent of the shares in A Ltd., the abovementioned condition will be satisfied if shareholders holding not less than 3/4 (in value) of the remaining 80 per cent of the shares in A Ltd., *i.e.*, 60 per cent thereof (3/4 × 80), become shareholders of X Ltd., by virtue of the amalgamation. Where, however, the whole of the share capital of a company is held by another company, the merger of the two companies will qualify as an amalgamation within section 2(*1B*), if the other two conditions are fulfilled—Circular No. 5-P, dated October 9, 1967.

2. For the purpose of condition (3), "shareholders" may be equity shareholders or preference shareholders. Consequently, persons holding at least 75 per cent of the equity and preference shares (in value) in the amalgamating company should become shareholders (by holding equity or preference shares or both) in the amalgamated company.

516.1-2 *TRANSACTIONS NOT TREATED AS "AMALGAMATION"* - Section 2(*1B*) specifically provides that in the following two cases there is no "amalgamation" for the purpose of the Income-tax Act, though the element of merger exists :

a. where the property of the company which merges is sold to the other company and the merger is a result of a transaction of sale ;

b. where the company which merges is wound up in liquidation and the liquidator distributes its property to the other company.

In these two cases, there would not be an "amalgamation" within the meaning of section 2(*1B*).

516.2 ***Actual cost and written down value when assets are transferred in a scheme of amalgamation*** - It is covered by the following two provisions—

516.2-1 *WHEN A CAPITAL ASSET (OTHER THAN A BLOCK OF ASSET) IS TRANSFERRED [EXPLN. 7 TO SEC. 43(1)]* - Where an asset is transferred, in a scheme of amalgamation, to an Indian company, the actual cost of the transferred asset will be taken to be the same as it would have been if the amalgamating company had continued to hold the capital asset for the purpose of its own business.

516.2-2 *WHEN A BLOCK OF ASSET IS TRANSFERRED [EXPLN. 2 TO SEC. 43(6)]* - Where in any previous year, any block of assets is transferred in a scheme of amalgamation by the amalgamating company to the amalgamated company, then actual cost of block of assets in the case of amalgamated company, shall be the written down value* of block of assets as in the case of amalgamating company for the immediately preceding previous year as reduced by the amount of depreciation actually allowed in relation to the said previous year. This rule is, however, applicable only if the amalgamated company is an Indian company.

Provisions illustrated - See problem 109-7-2dP1.

516.3 ***Transfer of capital assets in amalgamation - When not treated as "transfer"*** - By virtue of section 47, the following are not treated as transfer—

516.3-1 *TRANSFER OF CAPITAL ASSETS TO AMALGAMATED INDIAN COMPANY [SEC. 47(vi)]* - Any transfer, in scheme of amalgamation of capital assets by the amalgamating company to the amalgamated company is not taken as "transfer" if the following conditions are satisfied—

*Without reducing therefrom unabsorbed depreciation relating to earlier years—***CIT** v. ***Kothari Industrial Corpn. Ltd.*** [2006] 156 Taxman 240 (Mad.).

a. the scheme of amalgamation satisfies the conditions of section 2(*1B*); and

b. the amalgamated company is Indian company.

516.3-2 *TRANSFER OF SHARES IN AN INDIAN COMPANY HELD BY A FOREIGN COMPANY TO ANOTHER FOREIGN COMPANY IN A SCHEME OF AMALGAMATION [SEC. 47(via)]* - By virtue of section 47(*via*), if the following conditions are satisfied, the transaction is not treated as "transfer"—

a. shares in an Indian company are held by a foreign company;

b. the business of the above foreign company (including shares mentioned above) is taken over by another foreign company in a scheme of amalgamation;

c. at least 25 per cent of the shareholders of the amalgamating foreign company continue to remain shareholders of the amalgamated foreign company; and

d. such transfer does not attract tax on capital gains in the country in which the amalgamating company is incorporated.

516.3-3 *ALLOTMENT OF SHARES IN AMALGAMATED COMPANY TO THE SHAREHOLDERS OF AMALGAMATING COMPANY [SECS. 47(vii) AND 49(2)]* - Any transfer by a shareholder in a scheme of amalgamation of shares held by him in the amalgamating company shall not be regarded as transfer if—

a. transfer is made in consideration of allotment to him of shares in the amalgamated company ; and

b. amalgamated company is an Indian company.

According to section 49(2), in the aforesaid cases, the cost of shares of the amalgamating company shall be cost of shares of the amalgamated company.

Provisions illustrated - X Ltd., an Indian company, takes over the business of Y Ltd. in a scheme of amalgamation of the two companies. Z has purchased 100 shares in Y Ltd. in 1994 for Rs. 60 per share. As per the scheme of amalgamation, he gets 50 shares in X Ltd. in lieu of 100 shares in Y Ltd. Consequently, the cost of shares in X Ltd. will be taken as Rs. 120 per share [*i.e.*, Rs. 6,000, being cost of 100 shares in Y Ltd. ÷ 50 shares in X Ltd.].

■ The following points should be noted in this regard —

1. To find out whether or not shares in the amalgamated company are long-term capital asset or not, the period of holding shall be determined from date of acquisition of shares in the amalgamating company.

2. The indexation will start from the date of allotment of shares in the amalgamated company.

3. If besides shares in the amalgamated company, the shareholders of amalgamating company are allotted something more, say bonds or cash, etc., in consideration of transfer of their shares in the amalgamating company, then the shareholders cannot get the benefit under section 47(*vii*) and such transfer shall be chargeable to capital gains—*CIT* v. *Gautam Sarabhai Trust* [1988] 173 ITR 216 (Guj.).

516.4 ***Consequences if capital assets are transferred as stock-in-trade [Sec. 43C]*** - Where an asset [not being an asset referred to in section 45(2)] which has become the property of an amalgamated company under a scheme of amalgamation, is sold (after February 29, 1988), as stock-in-trade, then, in computing the profits and gains from the sale of such asset, the cost of acquisition of the asset to the amalgamated company shall be the cost of acquisition of the asset to the amalgamating company, as increased by the cost, if any, of any improvement made thereto and the expenditure incurred wholly and exclusively in connection with such transfer.

The provisions of section 43C is applicable to the following cases of revaluation :

i. where the stock-in-trade of the amalgamating company is taken over at revalued price by the amalgamated company under the scheme of amalgamation ;

ii. where a capital asset of the amalgamating company is taken over as stock-in-trade by the amalgamated company after revaluation under the scheme of amalgamation.

The situation referred to at (*ii*) above will, in turn, cover three situations :

a. where the capital asset is converted into stock-in-trade by the amalgamating company with revaluation and the revalued asset is taken over by the amalgamated company under a scheme of amalgamation ;

b. where the capital asset is taken over as stock-in-trade by the amalgamated company at a revalued price at the time of amalgamation ;

c. where the capital asset of the amalgamating company is taken over by the amalgamated company under a scheme of amalgamation as a capital asset and then converted into stock-in-trade and revalued.

In a case referred to at (*c*) above, where the revaluation and conversion of capital asset into stock-in-trade takes place in the hands of the amalgamated company, the provision of section 45(2) is applicable [for section 45(2), *see* para 176.1]. So in such a case, the provision of section 43C does not apply. However, where the stock-in-trade referred to in item (*i*) as well as at (*a*) and (*b*) above are sold after February 29, 1988, the provisions of section 43C shall apply.

Provisions illustrated - X Ltd. purchases an immovable property on April 6, 1984 for Rs. 2,00,000 and spends Rs. 10,000 for making some alterations. This asset is later on transferred to Y Ltd., which is mainly dealing in immovable property, at Rs. 2,40,000 in the scheme of amalgamation of the two companies. Y Ltd. sells the stock-in-trade for Rs. 5 lakh on May 6, 2008. Business income of Y Ltd. will be Rs. 2.90 lakh (*i.e.*, Rs. 5 lakh *minus* cost of the capital asset to X Ltd. : Rs. 2 lakh *minus* improvement expenses : Rs. 10,000).

516.5 ***Carry forward and set-off of loss and depreciation - When permissible in the hands of amalgamated company [Sec. 72A]*** - If the following conditions are satisfied, then the accumulated loss and the unabsorbed depreciation* of the amalgamating company shall be deemed to be loss/depreciation of the amalgamated company for the previous year in which the amalgamation is effected—

1. Condition one - There is an amalgamation of a company owning industrial undertaking**, ship or a hotel with another company; or a banking company with a SBI or any subsidiary of SBI. From the assessment year 2008-09, section 72A is also applicable in the case of an amalgamation of a public sector airlines with another public sector airlines. For this purpose, an industrial undertaking is an undertaking engaged in the manufacture or processing of goods, or the manufacture of computer software or the business of generation or distribution of electricity or any other form of power or mining or the construction of ships, aircrafts or rail systems, the business of providing telecommunication services whether basic or cellular, including radio paging, domestic satellite service, network of trunking, broadband network and internet services.

2. Condition two - The amalgamating company has been engaged in the business, in which the accumulated loss occurred or depreciation remains unabsorbed, for 3 or more years.

3. Condition three - The amalgamating company has held continuously as on the date of the amalgamation at least three-fourths of the book value of fixed assets held by it two years prior to the date of amalgamation.

4. Condition four - The amalgamated company continues to hold at least three-fourths in the book value of fixed assets of the amalgamating company which is acquired as a result of amalgamation for five years from the effective date of amalgamation.

5. Condition five - The amalgamated company continues the business of the amalgamating company for a minimum period of 5 years from the date of amalgamation.

6. Condition six - The amalgamated company, which has acquired an industrial undertaking of the amalgamating company by way of amalgamation, shall achieve the level of production of at least 50 per cent of the installed capacity of the said undertaking before the end of 4 years from the date of amalgamation and continue to maintain the said minimum level of production till the end of 5 years from the date of amalgamation.

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*Unabsorbed depreciation includes unabsorbed capital expenditure on scientific research/family planning—***ITO** v. ***Mahyco Vegetable Seeds Ltd.*** [2008] 25 SOT 46 (Mum.).

Hospital is not an industrial undertaking—*CIT* v. ***Apollo Hospitals Enterprises Ltd.*** [2008] 171 Taxman 397 (Mad.).

However, the Central Government, on an application made by the amalgamated company may relax this condition.

7. Condition seven - The amalgamated company shall furnish to the Assessing Officer a certificate in Form No. 62, duly verified by an accountant, with reference to the books of account and other documents showing particulars of production, along with the return of income for the assessment year relevant to the previous year during which the prescribed level of production is achieved and for subsequent assessment years relevant to the previous years falling within 5 years from the date of amalgamation.

▪ *Consequences when the above conditions are satisfied* - If the above conditions are satisfied, then accumulated business loss and unabsorbed depreciation of the amalgamating company shall be deemed to be loss and depreciation of the amalgamated company for the previous year in which amalgamation is effected.

▪ *Consequences when the above conditions are not satisfied after adjusting loss/depreciation* - In case the above specified conditions are not fulfilled, then that part of brought forward of loss and unabsorbed depreciation which has been set off by the amalgamated company shall be treated as the income of the amalgamated company for the year in which the failure to fulfil the conditions occurs.

516.5-1 ***SET OFF OF LOSSES OF A BANKING COMPANY AGAINST THE PROFIT OF A BANKING INSTITUTION UNDER A SCHEME OF AMALGAMATION [SEC. 72AA, APPLICABLE FROM THE ASSESSMENT YEAR 2005-06]*** - Section 72AA has been inserted with effect from the assessment year 2005-06 with a view to providing carry forward and set off of accumulated loss and unabsorbed depreciation allowance of a banking company against the profits of a banking institution under a scheme of amalgamation sanctioned by the Central Government.

▪ *Condition* - Section 72AA would be applicable if the following conditions are satisfied—

1. There is an amalgamation of a "banking company" with any other "banking institution". Banking company for this purpose means a company which transacts the business of banking in India. A manufacturing or trading company which accepts deposits of money from the public merely for the purpose of financing its business shall not be deemed to transact the business of banking. A banking institution for this purpose means any banking company and includes State Bank of India or a scheduled bank.

2. The amalgamation is sanctioned and brought into force by the Central Government under section 45(7) of the Banking Regulation Act, 1949.

3. The provisions of section 2(1B)(*i*)/(*ii*)/(*iii*) may or may not be satisfied.

4. The provisions of section 72A may or may not be satisfied.

▪ *Consequences if the above conditions are satisfied* - If the above conditions are satisfied, the accumulated loss and unabsorbed depreciation of the amalgamating banking company shall be deemed to be the loss or the allowance for depreciation of the banking institution for the previous year in which the scheme of amalgamation is brought into force.

For this purpose, "accumulated loss" means so much of the loss of the amalgamating banking company under the head "Profits and gains of business or profession" which such amalgamating banking company, would have been entitled to carry forward and set off under the provisions of section 72 if the amalgamation had not taken place. It does not, however, include speculative business loss. "Unabsorbed depreciation" means so much of the allowance for depreciation of the amalgamating banking company which remains to be allowed and which would have been allowed to such banking company if amalgamation had not taken place.

516.5-P1 *XY Ltd. wants to amalgamate with PQ Ltd. on June 30, 2008. You are required to find out the tax implication in respect of the following losses/allowances of XY Ltd. in the assessments of XY Ltd. (i.e., amalgamating company) and PQ Ltd. (i.e., amalgamated company).*

Unabsorbed depreciation allowance of the previous year 1998-99 : Rs. 36,000 ; brought forward business loss of the previous year 2000-01 : Rs. 10,00,000 ; unabsorbed scientific research expenditure : Rs. 11,000 ; bad debts :

Rs. 15,000 ; capital gain arising on transfer of assets to PQ Ltd. : Rs. 2,50,000 and brought forward capital loss Rs. 40,000. Also discuss whether PQ Ltd. can claim deduction under section 80-IA or 80-IB in respect of industrial undertaking taken over from XY Ltd.

SOLUTION :

The following Table highlights the tax implications in respect of various items given in the problem on the assumption that assets are transferred in a scheme of amalgamation which satisfies the provisions of section 2(*1B*).

Loss/allowances of XY Ltd. before amalgamation	Tax implication in the hands of	
	PQ Ltd.	XY Ltd.
Unabsorbed depreciation of 1998-99 : Rs. 36,000	If amalgamation satisfies the conditions of section 72A [*see* para 516.5] it is deductible, otherwise it is not deductible	As XY Ltd. ceased to exist after amalgamation, it is not entitled for deduction.
Brought forward business loss of 2000-01 : Rs. 10,00,000	If amalgamation satisfies conditions of section 72A [*see* para 516.5] it can be set-off and carried forward by PQ Ltd.; otherwise such right is not available	XY Ltd. cannot carry it forward, as it has ceased to exist after amalgamation.
Unabsorbed scientific research expenses : Rs. 11,000	Allowed subject to conditions of section 35 [*see* para 114]	It cannot be carried forward, as XY Ltd. has ceased to exist.
Bad debts : Rs. 15,000	Allowed	It is not allowed as deduction as XY Ltd. ceased to exist after amalgamation.
Capital gain : Rs. 2,50,000	It is not taxable in the hands of PQ Ltd. If, however, assets acquired in the scheme of amalgamation are sold by PQ Ltd., cost of acquisition for the purpose of computing capital gain would be cost to XY Ltd. (indirectly Rs. 2,50,000 will merge in capital gain arising at the time of sale of assets by PQ Ltd.)	It is not taxable, as transfer of assets in a scheme of amalgamation to an Indian company does not amount to "transfer" for the purpose of charging tax on capital gains.
Brought forward capital loss : Rs. 40,000	It cannot be set-off and carried forward by PQ Ltd.	It cannot be carried forward by XY Ltd., as it ceased to exist after amalgamation.

Note : As benefit of deduction under section 80-IA or 80-IB is attached to the undertaking (and not to the assessee), deduction under these sections would be available to PQ Ltd. even if the industrial undertakings are taken over from XY Ltd. [see para 253.1-3f]

516.5-P2 *A Co. Ltd. and B Co. Ltd., both being Indian companies, desire to merge together. At the end of the financial year 2008-09 (the financial year being the previous year for both the companies) the position of losses and allowances, in taxation, is as under :*

A Co. Ltd.

Assessment year	Unabsorbed trading loss (Rs. in lakh)	Unabsorbed depreciation (Rs. in lakh)
2005-06	*2*	*3*
2006-07	—	*2.5*
2007-08	—	*1*
2008-09	*3*	*2*
2009-10	*4*	*2*

B. Co. Ltd. - *There is no loss or depreciation remaining unabsorbed at the end of the assessment year 2009-10.*

As the tax consultant for both the companies advise them as to the basis and method in which the merger should be effected so as to reduce any adverse tax effects to the minimum. Discuss specifically the problems of taxation arising out of the merger in regard to the undernoted matters :

Discuss chargeability of tax on capital gains, if any, in the hands of the shareholders and/or the companies.

SOLUTION :

In the aforesaid problem, merger can take three different forms—A Ltd. merges with B Ltd. (A Ltd. goes out of existence), B Ltd. merges with A Ltd. (B Ltd. goes out of existence), and A Ltd. and B Ltd. merge in a new company : C Ltd. (both A Ltd. and B Ltd. goes out of existence).

Amalgamation can take the following three different forms :

a. it may not satisfy conditions of sections 2(*1B*) and 72A [see paras 516.1 and 516.5] ;

b. it may satisfy conditions of section 2(*1B*) but may not satisfy the conditions of section 72A ; and

c. it may satisfy conditions of section 2(*1B*) as well as section 72A.

Tax implication is highlighted in the following Table :

	If amalgamation does not satisfy conditions of sections 2(1B) and 72A	*If amalgamation satisfies conditions of section 2(1B) but does not fulfil requirement of section 72A*	*If amalgamation satisfies conditions of sections 2(1B) and 72A*
A Ltd. merges with B Ltd. (A Ltd. goes out of existence)	*Note 1*	*Note 3*	*Note 5*
B Ltd. merges with A Ltd. (B Ltd. goes out of existence)	*Note 2*	*Note 4*	*Note 4*
A Ltd. and B Ltd. merge with C Ltd.	*Note 1*	*Note 3*	*Note 5*

Notes :

1. In this situation (*a*) brought forward business loss/unabsorbed depreciation allowance of A Ltd. cannot be set-off and carried forward by B Ltd.; and (*b*) transfer of assets to B Ltd. will attract capital gains in the hands of A Ltd., because transfer will be treated as "transfer", as it does not satisfy conditions of section 2(*1B*).

2. In this case, (*a*) brought forward business loss/unabsorbed depreciation allowance of A Ltd. can be carried forward by it which can be set off even against profit arising in subsequent years from business undertaking taken over from B Ltd. (subject to time limit of 8 years in the case of brought forward business loss) ; and (*b*) transfer of assets of B Ltd. to A Ltd. will attract capital gain in the hands of B Ltd., as conditions of section 2(*1B*) are not satisfied.

3. Here (*a*) brought forward business loss/unabsorbed depreciation allowance of A Ltd. cannot be set off and carried forward by B Ltd. ; and (*b*) transfer of assets to B Ltd. will not attract capital gains in the hands of A Ltd., as transfer of assets, in a scheme of amalgamation satisfying conditions of section 2(*1B*), does not amount to "transfer" for the purpose of computation of capital gain.

4. In this situation, propositions stated in Notes 2(*a*) and 3(*b*) will hold good.

5. In this case, B Ltd. can set off and carry forward brought forward business loss/unabsorbed depreciation of A Ltd. Also propositions stated in Note 3(*b*) will apply.

516.5-P3 *Company A is proposed to be merged with company B. The following are the particulars of the former company :*

	Rs.
Unabsorbed depreciation	*2,50,65,000*
Unabsorbed business losses	*1,15,10,000*

Consider which of the benefits can be availed of by company B and advise the latter on the condition to be fulfilled to claim each such benefit.

SOLUTION :

There is no indication in the question whether merger of company A and company B satisfies conditions of sections 2(*1B*) and 72A [see paras 516.1 and 516.5]

Answer to the given problem can be given under the following three situations :

a. if the merger is not "amalgamation" within the meaning of section 2(*1B*) ; or

b. if the merger is an "amalgamation" within section 2(*1B*) but it does not fulfil conditions of section 72A ; or

c. if the merger satisfies conditions of section 2(*1B*) as well as section 72A.

Under the aforesaid situations, the position regarded the set off of the unabsorbed loss/allowances by company B will be as under :

	Whether company B can set off unabsorbed allowance/loss of company A:		
	Situation (a)	Situation (b)	Situation (c)
Unabsorbed depreciation of Rs. 2,50,65,000	No	No	Yes
Unabsorbed losses of Rs. 1,15,10,000	No	No	Yes

As is evident from the aforesaid chart, all unabsorbed losses/allowances can be set off if the merger satisfies requirement of section 72A. Alternatively, in order to retain the advantage of claiming set off of unabsorbed loss/ allowance, the business of company B may be taken over by company A. In that case all unabsorbed losses/ allowances can be set off by company A, even if the merger does not satisfy the conditions of sections 2(*1B*) and 72.

516.5-P4 *Company X which has an accumulated loss of Rs. 5,00,000 and unabsorbed depreciation of Rs. 3,00,000 wants to reorganize its business by amalgamating with a rival company Y, which is engaged in the same line of production but with a smaller capital, but has an efficient management set up and more modern machinery. Company Y is agreeable to the amalgamation.*

What are the alternative courses available to the companies for effecting the merger and how would you advise them as to the best course of action?

SOLUTION :

The alternatives for merger that are available to X and Y are : (*i*) merger of X into Y, whereby X goes out of existence ; (*ii*) merger of Y into X, whereby Y goes out of existence ; and (*iii*) merger of X and Y into a new company, whereby a new company, say Z, is formed and both X and Y go out of existence.

All the three mergers can take place under one of the following situations—

a. If the merger is not an "amalgamation" within the meaning of section 2(*1B*).

b. If the merger is an "amalgamation" within the meaning of section 2(*1B*), though it does not satisfy provisions of section 72A.

c. If the merger satisfies conditions of sections 2(*1B*) and 72A.

[For conditions of section 2(*1B*), see para 516.1 and for provisions of section 72A, see para 516.5].

Under the aforesaid situations, the set off of accumulated loss of Rs. 5,00,000 and unabsorbed depreciation of Rs. 3,00,000 is possible in the following cases :

	Whether set off of unabsorbed loss/ depreciation allowance is possible?		
	Situation (a)	Situation (b)	Situation (c)
i. Merger of X into Y (X goes out of existence after merger)	No	No	Yes
ii. Merger of Y into X (Y goes out of existence)	Yes	Yes	Yes
iii. Merger of X and Y into Z (X and Y go out of existence, Z is formed as a new company)	No	No	Yes

To conclude, it can be said that if the conditions of section 72A [see para 516.5] are satisfied, any of the three alternatives for mergers can be adopted, as in all the cases the loss can be set off by the amalgamated company. If, however, conditions of section 72A are not satisfied, alternative (*ii*) (*i.e.*, merger of company Y into X) should be adopted, as in this case, company X would be able to carry forward and set off of loss/depreciation even if the merger does not fulfil the requirement of section 2(*1B*). This kind of merger is also known as reverse merger.

516.6 ***Expenditure on amalgamation/demerger [Sec. 35DD]*** - Where an assessee, being an Indian company, incurs expenditure (on or after April 1, 1999), wholly and exclusively for the purpose of amalgamation or demerger, the assessee shall be allowed a deduction equal to one-fifth of such expenditure for 5 successive previous years beginning with the previous year in which amalgamation or demerger takes place.

No deduction shall be allowed in respect of the above expenditure under any other provisions of the Act.

The following points should be noted—

1. If expenditure is allowed as deduction under section 35DD, then the same is not allowed as deduction under any other provision of the Act.

2. Unlike section 37(1) which prohibits deduction in respect of capital expenditure, section 35DD does not stipulate any such restriction. Even capital expenditure, if it is wholly and exclusively incurred for the purpose of the amalgamation or demerger, would be available as a deduction under section 35DD.

3. In the case of amalgamation, the amalgamating company ceases to exist. Therefore, the amalgamating company can claim one-fifth of amalgamation expenditure as deduction in the year in which amalgamation takes place. In the subsequent year (as the amalgamating company ceases to exist) deduction will not be available. On the other hand, the amalgamated company can claim deduction in the year of amalgamation and the next four years. Therefore, as far as possible amalgamation expenditure should be borne by the amalgamated company.

516.7 ***Consequences of amalgamation*** - One should note the following consequences of amalgamation—

- Sec. 35 [*see* para 114.10]
- Sec. 35AB [*see* para 116]
- Sec. 35ABB [*see* para 117.4]
- Sec. 35D [*see* para 121.8]
- Sec. 35DDA [*see* para 121B]
- Sec. 35E [*see* para 122.7]
- Sec. 41 [*see* para 156.1-1]
- Sec. 80-IA/80-IB [*see* para 253.1-3f].

516.8 ***Date of amalgamation*** - Every scheme of amalgamation has to necessarily provide a date with effect from which the amalgamation shall take place. It is true that while sanctioning the scheme, it is open to the court to modify the said date and prescribe such date of amalgamation as it thinks appropriate on the facts and circumstances of the case. If the court so specifies a date, there is little doubt that such date would be the date of amalgamation. Where, however, the court does not prescribe any specific date but merely sanctions the scheme presented to it, it should follow that the date of amalgamation is the date specified in the scheme as 'the transfer date'. It cannot be otherwise.

Demerger

517. The provisions regulating "demerger" are given below—

517.1 ***Meaning of demerger [Sec. 2(19AA)]*** - The company whose undertaking is transferred pursuant to demerger is known as "demerged" company. The company to which the undertaking is transferred is known as "resulting" company.

Under the Act, "demerger" should satisfy the following conditions—

- *Condition one - Entities involved should be companies* - Under the Income-tax Act, demerger is possible between companies only. Consequently, a demerger of an undertaking of a firm with a company would not be covered by the definition under section 2(*19AA*) although such a demerger may be permitted under the Companies Act, 1956.
- *Condition two - Sections 391 to 394 of the Companies Act should be satisfied* - Conditions of sections 391 to 394 of the Companies Act should be satisfied.
- *Condition three - It involves transfer of an undertaking* - The definition under section 2(*19AA*) applies only in respect of transfer of an "undertaking".

Explanation 1 defines the term "undertaking". The term includes any part of an undertaking, or a unit or division of an undertaking or a business activity taken as a whole, but does not include individual assets or liabilities or any combination thereof not constituting a business activity.

To put it differently, a part of undertaking will not be "undertaking" for the purposes of the definition if the assets/liabilities of the specific part of the undertaking cannot by themselves constitute a business activity. Likewise, transfer of assets which excludes a few significant assets without which the business cannot be carried on effectively, may not be considered as a transfer of business.

▪ *Condition four - All property of the undertaking should be transferred to the resulting company* - All the property of the undertaking being transferred by the demerged company becomes the property of the resulting company.

The following points should be noted—

- One has to see whether in actuality all the properties are transferred, and the resulting company is able to carry on the activities of the demerged company as a going concern. If this is the case, then the condition regarding transfer of property should also be deemed to have been satisfied.
- Section 2(*19AA*) requires that all the properties of the undertaking should be transferred. It does not, however, state that any asset (not forming part of an undertaking) should not be transferred. Consequently, if a specific asset is transferred, out of prudence that it forms part of the undertaking (whereas it does not form part of the undertaking) the benefits attached to demerger cannot be denied.
- If an asset is used partly for the unit, which is transferred and partly for other units, such an asset may not be transferred.
- Property of the undertaking, which is transferred in a scheme of demerger includes all assets (fixed, current, circulating) but does not include miscellaneous expenditure (like preliminary expenses, discount allowed on issue of shares, and other deferred revenue expenditure), which appears on assets side of a balance sheet.

▪ *Condition five - The resulting company should take over all liabilities of the undertaking* - All the liabilities relatable to the undertaking being transferred by the demerged company, should become the liabilities of the resulting company.

For this purpose, the liabilities shall include :

a. the liabilities which arise out of the activities or operations of the undertaking;

b. the specific loans or borrowings (including debentures) raised, incurred and utilised solely for the activities or operations of the undertaking; and

c. in cases, other than those referred to in (*a*) or (*b*), so much of the amounts of general or multipurpose borrowings, if any, of the demerged company as stand in the same proportion in which the value of the assets transferred in a demerger bears to the total value of the assets of such demerged company immediately before the demerger.

The following points should be noted—

- For the purpose of (*c*) (*supra*), the computation shall be made on the following lines - amount of general/multi-purpose borrowing of the demerged company × book value of assets (ignoring the effect of revaluation if any) transferred in the demerger ÷ total book value of assets (ignoring the effect of revaluation) of the demerged company before demerger.
- The liability for the purpose of setting up the undertaking shall be considered as a liability.
- As contingent liabilities are not liabilities of the demerged company immediately before demerger, the resulting company may or may not take over such liabilities.

▪ *Condition six - Liabilities/properties are to be transferred at book value* - The properties and the liabilities of the undertaking are transferred at book values appearing in the books of account of the demerged company immediately before the demerger. *Explanation 3* provides that any change in the value of assets consequent to their revaluation shall not be taken into consideration.

The following points should be noted—

- Revaluation made in any year (maybe in the year of demerger or before that year) shall be ignored.
- If inventory is valued at market value or net realisable value, it does not amount to revaluation.

▪ *Condition seven - Shares in the resulting company are issued to the shareholders of demerged company* - The resulting company issues shares to the shareholders of the demerged company on a proportionate basis as a consideration for demerger.

The word 'proportionate' suggests that, for each share of the demerged company, the ratio of shares in demerged company to the share in resulting company should be identical. This ratio is to be maintained separately for each class of shares. In case of odd lot shares, the consideration for the 'odd lot' may be discharged in the form of cash.

▪ *Condition eight - Person holding 75 per cent shares in the demerged company to become shareholders in the resulting company* - The shareholders holding not less than three-fourths in value of the shares in the demerged company (other than the shares already held therein immediately before the demerger, or by a nominee for, the resulting company or, its subsidiary) become shareholders of the resulting company.

The following points should be noted—

- The resulting company should issue its shares to the shareholders of demerged company in consideration of transfer of undertaking by the demerged company. The resulting company cannot transfer its investments to the shareholders of demerged company.
- If the shareholders in demerged company includes the resulting company or its nominees or its subsidiary, then shareholding by such entities shall not be considered for determining the aforesaid "three fourth" criteria. For this purpose, it is only the shares held immediately before the demerger by the resulting company, etc., that have to be excluded, and the consent of the three-fourths of the remaining shareholders have to be obtained. Any acquisition of shares by the resulting company, etc., after the appointed date cannot be reduced for the purpose of calculating three-fourth shareholders.
- 'Shares' include all classes of shares whether equity shares or preference shares. Consequently, 'three-fourths in value of shares' means three-fourths in value of the aggregate share capital and not merely equity capital of the demerged company.

For instance, the following are shareholders of D Ltd. (demerged company) [one of the undertakings of D Ltd. is transferred in a scheme of demerger to R Ltd. (resulting company)].

Face value in thousand Rs.

A	100	-
B	400	-
C	200	-
D	500	-
R Ltd.	300	100
IDBI	150	130
Public	50	70
Total	1700	300

Total paid up capital is Rs. 20,00,000. After excluding shares held by R Ltd., the remaining paid-up capital is Rs. 16,00,000. 75 per cent of Rs. 16,00,000 is held by any of the following group of shareholders—

Group 1 - A, B, C and D

Group 2 - B, C, D and public

Group 3 - A, B, D, IDBI

Group 4 - A, C, D, IDBI and public

		Rs.
15% of Rs. 13,00,000		1,95,000
Number of days when the assets are used by—		
- X Ltd.		95 days
- Y Ltd.		270 days
Share of X Ltd. in depreciation (95 ÷ 365 of Rs. 1,95,000)		50,753
Share of Y Ltd. (Rs. 1,95,000 – Rs. 50,753)		1,44,247
Depreciation to X Ltd.		
Depreciated value of the block on April 1, 2008		30,00,000
Add : Cost of Plant E		1,00,000
Less : Written down value of Unit I (being written down value for the immediately preceding year) [it is not "immediately preceding demerger"]		(-) 13,00,000
Written down value on March 31, 2009		18,00,000
Depreciation		
- On Unit I	50,753	
- On Unit II	2,70,000	3,20,753
Depreciated value of the block on April 1, 2009		14,79,247
Depreciation to Y Ltd.		
Depreciated value of the block on April 1, 2008		20,00,000
Add : Actual cost of Plant Q		2,60,000
Add : Actual cost of Unit I acquired in a scheme of demerger (being written down value in the hands of demerged company immediately before demerger; as per *Explanation 2B* to section 43(6), *i.e.*, Rs. 13,00,000 *minus* Rs. 50,753)		12,49,247
Written down value on March 31, 2009		35,09,247
Depreciation @ 15% on—		
- Unit I	1,44,247	
- Plant Q (1/2 of 15% of Rs. 2,60,000)	19,500	
- Other assets [15% of (Rs. 35,09,247 – Rs. 12,49,247 – Rs. 2,60,000)]	3,00,000	4,63,747
Depreciated value of the block on April 1, 2009		30,45,500

517.3 ***Demerger vis-a-vis capital gains*** - The Act has made special provisions regulating tax incidence on capital gains in the case of demerger.

517.3-1 ***WHEN IT IS NOT TREATED AS TRANSFER*** - The following are not treated as transfer by virtue of section 47—

a. any transfer in a demerger of a capital asset by the demerged company to resulting company provided that resulting company is an Indian company [sec. 47(*vib*)] ;

b. any transfer of shares held in an Indian company by a demerged foreign company to the resulting foreign company if the following conditions are satisfied :

i. the shareholders holding not less than three-fourths in value of shares of the demerged foreign company continue to remain shareholders of the resulting foreign company ; and

ii. such transfer does not attract tax on capital gains in the country, in which the demerged foreign company is incorporated [sec. 47(*vic*)] ;

c. any transfer or issue of shares by the resulting company in a scheme of demerger to the shareholders of the demerged company if the transfer or issue is made in consideration of demerger of the undertaking [sec. 47(*vid*)].

However, the distinction between section 47(*vic*) and section 2(*19AA*) should be noted. Under section 2(*19AA*), while applying the limit of three-fourths in value of the shares, the shares already held in the demerged company immediately before the demerger by (or by a nominee for) the resulting company, (or its subsidiary) should be excluded, a similar provision is not made in section 47(*vic*).

517.3-2 *COST OF ACQUISITION OF SHARES IN RESULTING COMPANY AND DEMERGED COMPANY [SEC. 49(2C)/(2D)]* - Cost of acquisition of the shares in the resulting company shall be the amount which bears to the cost of acquisition of shares held by the assessee in the demerged company the same proportion as the net book value of the assets transferred in a demerger bears to the net worth of the demerged company immediately before such demerger. For this purpose "net worth" shall mean the aggregate of the paid-up share capital and general reserves as appearing in the books of account of the demerged company immediately before the demerger.

▪ The following points should be noted —

1. Cost of acquisition of the original shares held by the shareholder in the demerged company shall be deemed to have been reduced by the amount as mentioned above.

2. To find out whether or not shares in the resulting company are long-term capital asset, the period of holding shall be determined from the date of acquisition of shares in the demerged company.

3. The indexation will start from the date of allotment of shares in the resulting company.

517.4 ***Expenditure on demerger [Sec. 35DD]*** - *See* para 516.6.

517.5 ***Carry forward and set-off of losses/depreciation - When permissible in the hands of resulting company [Sec. 72A]*** - In the case of demerger, the accumulated loss and unabsorbed depreciation of the demerged company will be allowed to be carried forward and set off in the hands of the resulting company.

The Central Government may, for this purpose, by notification in the Official Gazette, specify such conditions as it considers necessary to ensure that the demerger is for genuine business purposes.

How to compute the loss/depreciation allowance which will be carried forward by the resulting company - If the loss/depreciation is directly relatable to the undertakings transferred to the resulting company, then such loss/depreciation shall be allowed to be carried forward in the hands of the resulting company.

Where, however, such loss or unabsorbed depreciation is not directly relatable to the undertakings transferred to the resulting company, it will be apportioned between the demerged company and the resulting company in the same proportion in which the assets of the undertakings have been retained by the demerged company and transferred to the resulting company, and it will be allowed to be carried forward and set off in the hands of the demerged company or the resulting company, as the case may be.

517.6 ***Provisions illustrated*** - To have better understanding; the following illustration is given—

517.6-P1 *D Ltd. (demerged company) wants to transfer one of its undertakings to R Ltd. (resulting company). D Ltd. is the holding company of R Ltd. The two companies are Indian companies.*

The following is the balance sheet of D Ltd. as on March 31, 2008 immediately before demerger.

(Rs. in thousand)

Equity share capital	*140,00*	Unit 1	
Capital reserve	*1,00*	*Land (acquired in 1990)*	*30,00*
Share premium	*2,99.290*	*Plant and machinery*	*60,00*
General reserve	*15,00*	*Stock-in-trade*	*4,00*
Revaluation reserve		*Sundry debtors*	*3,00*
- Land of Unit 1	*4,00*	*Deferred revenue expenditure*	*2,00*
- Building of Unit 2	*6,00*	Unit 2	
Loan (taken to purchase plant and machinery of Unit 1)	*22,00.710*	*Plant and machinery* *Building*	*36,00* *14,00*

Loan (general)	*3,00*	*Stock-in-trade*	*6,00*
Current liability		*Sundry debtors*	*4,00*
Unit 1	*7,00*	Other assets	
Unit 2	*1,00*	*Land and building*	*30,00*
Bank overdraft (general)	*8,00*	*Investment*	
		- Shares in R Ltd.	*8,00*
		- Shares in Tac Chem.	*2,00*
		Cash and bank	*10,00*
		Pre-incorporation expenses	*1,00*
	210,00		*210,00*

Other information—

1. Shareholders list of D Ltd. is as follows—A : 20 per cent, B : 40 per cent, C Ltd. : 30 per cent and UTI : 10 per cent.

2. Accumulated loss for tax purpose of D Ltd. up to the assessment year 2008-09 is Rs. 45 lakh.

3. D Ltd. wants to transfer Unit 1 to R Ltd. on April 1, 2008 by satisfying conditions of section 2(19AA).

4. The market value of assets of Unit 1 is as follows - Land : Rs. 69 lakh and plant and machinery : Rs. 49 lakh.

5. After the demerger, the face value of equity shares of D Ltd. will be reduced to Rs. 6 per share.

6. Securities transaction tax is not applicable.

SOLUTION :

R Ltd. should take over the following assets and liabilities pertaining to D Ltd.—

	(Rs. in thousand)
Land (Rs. 30 lakh *minus* Rs. 4 lakh)	26,00
Plant and machinery	60,00
Stock	4,00
Debtors	3,00
Total assets (at book value)	93,00
Less : Liabilities	
Loan taken to purchase plant and machinery	22,00.71
Current liabilities	7,00
Loan (general) [see Note]	1,41.62
Bank overdraft (general) [see Note]	3,77.67
Consideration	58,80

The following points should be noted—

1. Total assets of D Ltd. are Rs. 210 lakh. Out of which, the following shall be excluded : Deferred revenue expenditure of Unit 1 : Rs. 2 lakh, pre-incorporation expenditure : Rs. 1 lakh, revaluation reserve Unit 1 : Rs. 4 lakh and Unit 2 : Rs. 6 lakh. The balance is Rs. 197 lakh. The book value of assets of Unit 1 is Rs. 93 lakh. Therefore, general loan and bank overdraft shall be allocated to Unit 1 in ratio of 93/197 [i.e., Rs. 3 lakh × 93/197 : Rs. 1,41,624 and Rs. 8 lakh × 93/197 : Rs. 3,77,665].

2. The total consideration is Rs. 58,80,000. It will be paid by R Ltd. by issue of shares. Suppose shares are issued at par, then R Ltd. will issue shares to shareholders of D Ltd. as follows (a person holding 100 shares in D Ltd. will get 42 shares in R Ltd.)—

	Number of shares	Face value of shares (Rs.)
A (20%)	1,17,600	11,76,000
B (40%)	2,35,200	23,52,000
C Ltd. (30%)	1,76,400	17,64,000

	Number of shares	Face value of shares (Rs.)
UTI (10%)	58,800	5,88,000
	5,88,000	58,80,000

3. Accumulated loss of D Ltd., which will be set off and carry forward by R Ltd. under the provisions of section 72A will be Rs. 21,24,365 (*i.e.*, Rs. 45 lakh × 93 ÷ 197).

4. Market value of assets of Unit 1 is not taken into consideration for determining total consideration.

5. Shareholders of D Ltd. will get shares in R Ltd. By virtue of section 2(22)(*v*), it will not be treated as "dividend".

6. D Ltd. transfers Unit 1 to R Ltd. It is not treated as "transfer" for the purpose of capital gains by virtue of section 47(*vib*).

7. Shareholders of D Ltd. get shares in R Ltd. in lieu of reduction in share capital. It is not chargeable under the head "Capital gains", as it is not taken as "transfer" under section 47(*vid*).

8. Suppose land acquired from D Ltd. is transferred by R Ltd. on March 1, 2009 for 80 lakh, then amount of capital gain shall be determined as under —

Capital gain in the case of R Ltd.	*Rs.*
Sale proceeds	80,00,000
Less : Cost of acquisition	26,00,000
Short-term capital gain	54,00,000

In this case, the period of holding is taken from April 1, 2008 to March 1, 2009.

9. R Ltd. can claim depreciation in respect of plant and machinery acquired from D Ltd. For mode of computation, see para 517.2-3.

10. D Ltd. can claim depreciation in respect of remaining assets. For mode of computation, see para 517.2-3.

11. B who holds 5,60,000 (40% of 14,00,000 shares) in D Ltd., gets 2,35,200 shares in R Ltd. on April 1, 2008. Suppose 5,60,000 shares in D Ltd. were acquired by him as follows—

Lot	No. of shares	Date of acquisition	Rate per share (incl. brokerage) Rs.	Fair market value on April 1, 1981 Rs.
I	75,000	April 25, 1979	6	9
II	25,000	June 6, 1980	*Nil* (bonus share)	9
III	3,00,000	May 7, 1986	8	—
IV	1,00,000	July 11, 1991	*Nil* (bonus share)	—
V	60,000	March 28, 2008	7	—

After demerger, B holds 5,60,000 shares in D Ltd. (face value Rs. 6 per share) and 2,35,200 shares in R Ltd. (face value Rs. 10 per share). Suppose on March 15, 2009, B transfers shares in D Ltd. @ Rs. 17 per share and shares in R Ltd. @ Rs. 21 per share, then capital gain shall be computed as under—

	Lot I	Lot II	Lot III	Lot IV	Lot V
Number of shares in D Ltd. (*a*)	75,000	25,000	3,00,000	1,00,000	60,000
Number of shares in R Ltd. (a person who holds 100 shares in D Ltd. gets 42 shares in R Ltd.) (*b*)	31,500	10,500	1,26,000	42,000	25,200
Period of holding of shares in D Ltd. and R Ltd. [in respect of shares in R Ltd. the period of holding shall be taken from the date of acquisition of shares in D Ltd.— Sec. 2(42A), *Expln. 1*(*g*)]	April 25, 1979 to March 15, 2009	June 6, 1980 to March 15, 2009	May 7, 1986 to March 15, 2009	July 11, 1991 to March 15, 2009	March 28, 2008 to March 15, 2009

	Lot I	Lot II	Lot III	Lot IV	Lot V
Status long-term capital asset (LT) or short-term capital asset (ST)	*LT* *Rs.*	*LT* *Rs.*	*LT* *Rs.*	*LT* *Rs.*	*ST* *Rs.*
Cost per share in D Ltd.	6	*Nil*	8	*Nil*	7
Fair market value on April 1, 1981	9	9	—	—	—
Cost or market value on April 1, 1981, whichever is more (c)	9	9	8	*Nil*	7
Cost of acquisition for capital gain if there is no demerger [(a) × (c)] (d)	6,75,000	2,25,000	24,00,000	*Nil*	4,20,000
Cost of acquisition of shares in R Ltd. [see Note 1] [(d) × Rs. 58,80,000 ÷ Rs. 1,55,00,000] (e)	2,56,065	85,355	9,10,452	*Nil*	1,59,329
Cost of acquisition of shares in D Ltd. [see Note 2] [(d) - (e)] (f)	4,18,935	1,39,645	14,89,548	*Nil*	2,60,671
Computation of capital gains					
Shares in D Ltd.					
Sale proceeds [(a) × Rs. 17]	12,75,000	4,25,000	51,00,000	17,00,000	10,20,000
Less : Indexed cost of acquisition in the case of Lot I to IV [Note 3] or cost of acquisition in the Lot V]	24,38,202	8,12,734	61,92,264	*Nil*	2,60,671
Long-term capital gain	(-) 11,63,202	(-) 3,87,734	(-) 10,92,264	17,00,000	—
Short-term capital gain	—	—	—	—	7,59,329
Shares in R Ltd.					
Sale proceeds [(b) × Rs. 21]	6,61,500	2,20,500	26,46,000	8,82,000	5,29,200
Less : Indexed cost of acquisition in the case Lot I to IV [see Note 3] or cost of acquisition in the case of Lot V	2,56,065	85,355	9,10,452	*Nil*	1,59,329
Long-term capital gain	4,05,435	1,35,145	17,35,548	8,82,000	—
Short-term capital gain	—	—	—	—	3,69,871

Note—

1. Section 49(2C) provides that the cost of acquisition of the shares in the resulting company shall be the amount which bears to the cost of acquisition of shares held by the assessee in the demerged company the same proportion as the net book value of the assets transferred in a demerger bears to the net worth of the demerged company immediately before such demerger. For this purpose "net worth" shall mean the aggregate of the paid-up share capital and general reserves as appearing in the books of account of the demerged company immediately before the demerger. In this case net book value of assets transferred in demerger is Rs. 58,80,000. Net worth of D Ltd. immediately before demerger is Rs. 1,55,00,000 (*i.e.*, paid-up capital Rs. 1,40,00,000 + general reserve Rs. 15,00,000). Therefore, 58.80/155 of cost of acquisition of shares in D Ltd. is taken as cost of acquisition of shares in R Ltd.

2. As per section 49(2D), the cost of acquisition of the original shares held by the shareholder in the demerged company shall be deemed to have been reduced by the amount as so arrived under sub-section (2C) (as mentioned above).

3. Indexed cost of acquisition in respect of shares in D Ltd. and R Ltd. is computed as follows—

Lot	Cost of acquisition Rs.	CII of the year in which the asset was first held by the assessee	CII of the year in which the asset is transferred	Indexed cost of acquisition (2) X (4) ÷ (3) Rs.
(1)	(2)	(3)	(4)	(5)
D Ltd.				
I	4,18,935	100	582	24,38,202
II	1,39,645	100	582	8,12,734
III	14,89,548	140	582	61,92,264
IV	NA	199	582	NA
R Ltd.				
I	2,56,065	582	582	2,56,065
II	85,355	582	582	85,355
III	9,10,452	582	582	9,10,452
IV	NA	582	582	NA

517.7 ***Consequences of demerger*** - One should note the following consequences of demerger —

- Sec. 35AB [*see* para 116]
- Sec. 35ABB [*see* para 117.4]
- Sec. 35D [*see* para 121.8]
- Sec. 35DDA [*see* para 121B]
- Sec. 35E [*see* para 122.7]
- Sec. 41 [*see* para 156.1-1]
- Sec. 80-IA/80-IB [*see* para 253.1-3f].

517.8 ***Amalgamation* vis-a-vis *Demerger***- The key points of distinction between amalgamation and demerger are given below—

- An amalgamation has a reference to a company as a whole whereas a demerger has a reference to an undertaking of the company.

The amalgamating company will lose its identity in amalgamation whereas the demerged company may continue to exist after demerger.

- Demerger stipulates a transfer pursuant to a scheme of arrangement under sections 391 to 394, whereas there is no such requirement in case of amalgamation.
- Demerger requires transfer of undertaking on a going-concern basis whereas there is no such explicit requirement under the Act in case of amalgamation.

Conversion of sole proprietary business into company

518. If the following conditions are satisfied, then transfer of capital assets in case of conversion of sole proprietary business into company is not chargeable to tax by virtue of section 47(*xiv*)—

i. all assets and liabilities of the sole proprietary concern relating to the business immediately before the succession shall become the assets and liabilities of the company ;

ii. the shareholding of the sole proprietor in the company is not less than 50 per cent of the total voting power in the company and shareholding shall continue to so remain for a period of five years from the date of the succession ;

iii. the sole proprietor does not receive any consideration or benefit directly or indirectly, in any form or manner other than by way of allotment of shares in the company.

518.1 ***Is it possible to take back the exemption*** - *See* para 519.1-1.

518.2 ***Is it possible to set off and carry forward loss of sole proprietary by company*** - Section 72A gives the method of set off and carry forward of loss [*see* para 519.3].

Conversion of firm into company

519. The provisions regarding conversion of firm into company are given below —

519.1 ***Exemption under section 47(xiii)*** - By virtue of section 47(*xiii*), if the following conditions are satisfied, then transfer of capital assets in the case of conversion of a firm into company is not chargeable to tax—

i. all the assets and liabilities of the firm relating to the business immediately before the succession shall become the assets and liabilities of the company ;

ii. all the partners of the firm immediately before the succession become the shareholders of the company in the same proportion in which their capital accounts stood in the books of the firm on the date of succession ;

iii. the partners of the firm do not receive any consideration or benefit directly or indirectly, in any form or manner other than by way of allotment of shares in the company ; and

iv. the aggregate of the shareholding in the company of the partners of the firm is not less than 50 per cent of the total voting power in the company and their shareholding continues to be as such for a period of five years from the date of the succession.

The aforesaid conditions are also applicable if capital assets are transformed in the course of demutualisation or corporatisation of a recognised stock exchange in India as a result of which an association of persons or body of individuals is succeeded by a company.

519.1-1 *WITHDRAWAL OF EXEMPTION [SEC. 47A(3)]* - The following conditions should be satisfied—

1. A firm or proprietary concern is converted into company by satisfying conditions of section 47(*xiii*)/(*xiv*).

2. As conditions of section 47(*xiii*)/(*xiv*) [*see* paras 169.2-18 and 169.2-20] are satisfied, capital gain is not chargeable to tax in the hands of firm/sole proprietary concern.

3. If after conversion, any of the conditions of section 47(*xiii*)/(*xiv*) are not satisfied, then capital gain (which was not taxed earlier) will become chargeable to tax in the hands of company.

Provisions illustrated - X & Co. is a firm of X and Y (1:2) whose balance sheet as on April 1, 2008 is as follows —

Balance sheet of X & Co. as on April 1, 2008

	Rs.		Rs.
		Plant and machinery	80,000
Capital		House property (acquired in 1984-85)	2,00,000
X	1,00,000	Stock-in-trade	40,000
Y	2,00,000	Debtors	70,000
Sundry creditors	1,00,000	Bank and cash balance	10,000
	4,00,000		4,00,000

A Ltd. is incorporated on April 1, 2008 which takes over the assets and liabilities of X Co. as follows—

	Agreed valuation Rs.	Cost of acquisition for the purpose of income-tax Rs.
Plant and machinery	2,80,000	80,000
House property	10,00,000	2,00,000

	Agreed valuation Rs.	Cost of acquisition for the purpose of income-tax Rs.
Stock-in-trade	60,000	
Debtors	70,000	
Bank and cash balances	10,000	
Total	14,20,000	
Less : Sundry creditors	1,00,000	
Net consideration	13,20,000	
Equity shares (44,000 equity shares of Rs. 10) allotted to X by A Ltd.	4,40,000	
Equity shares (88,000 equity shares of Rs. 10) allotted to Y by A Ltd.	8,80,000	

Capital gain and business income of X & Co.

	Plant and machinery Rs.	House property Rs.	Stock-in-trade Rs.
Sale consideration	2,80,000	10,00,000	60,000
Less : Cost of acquisition or indexed cost of acquisition [Rs. 2,00,000 × 582/125]	80,000	9,31,200	40,000
Business income	-	-	20,000
Short-term capital gain	2,00,000	-	-
Long-term capital gain	-	68,800	-

In this case, the firm will pay tax in respect of business income of Rs. 20,000 and the capital gain of Rs. 2,68,800 will not be taxable in the hands of the firm as conversion of the firm into company is not treated as "transfer" by virtue of section 47(*xiii*).

One of the conditions of section 47(*xiii*) is that the aggregate of the shareholding in the company of the partners of the firm is not less than 50 per cent of the total voting power in the company and their shareholding continues to be as such for a period of five years from the date of the succession.

In other words, the aggregate shareholding of X and Y in A Ltd. should not be less than 50 per cent up till April 1, 2013. If suppose Y transfers all of his shares on April 6, 2010 to Z, then A Ltd. will be chargeable to tax in respect of Rs. 2,68,800 as profits and gains. It is not clear from the language of section 47A(3) as to the head under which the company would be taxed. However, having regard to the placement of section 47A(3) in the provisions relating to taxation of capital gains, it appears that it would be treated as capital gains. Consequently, A Ltd. will be chargeable to tax in respect of long-term capital gains of Rs. 68,800 and short-term capital gain of Rs. 2,00,000 and this will be deemed as income of the previous year 2010-11 (*i.e.*, the assessment year 2011-12).

519.1-2 ***HINTS FOR TAX PLANNING*** - X & Co. is a firm and is in possession of a plot of land, the current market value of which is Rs. 50 crore. If the plot is sold, the capital gains tax liability works out to say Rs. 8 crore.

If X & Co. is converted into X Ltd. by satisfying conditions of section 47(*xiii*) and X Ltd. transfers the plot of land at Rs. 50 crore, no capital gains tax liability arises in either hands.

It may be noted that section 49(1) deems the cost of the previous owner to be the cost to the assessee in respect of certain modes of acquisition of property by the assessee. It includes within its ambit cases like the transfer of a capital asset by gift, will and even transfers in the case of amalgamation of companies but the case of transfer by succession of firm or sole proprietary concern by a company are conspicuous by their absence.

519.2 ***Exemption under section 47(xi)*** - Exemption under section 47(*xi*) is available if the following conditions are satisfied —

a. transfer is made before January 1, 1999 ;

b. transfer is made by a person other than a company ;

c. transfer is made of a membership in a recognised stock exchange in India ;

d. it is transferred to a company ; and

e. consideration is paid by way of allotment of shares in the transferee-company to the transferor.

If all the aforesaid conditions are satisfied, then capital gain on transfer of stock exchange membership is not chargeable to tax.

519.3 ***Is it possible to set off and carry forward loss of firm by company [Sec. 72A(6)]*** - In cases of succession of business, whereby, a firm is succeeded by a company fulfilling the conditions laid down in section 47(*xiii*)[1] or a proprietary concern is succeeded by a company fulfilling the conditions laid down in section 47(*xiv*)[2], the accumulated loss and the unabsorbed depreciation (including unadjusted capital expenditure on scientific research) of the predecessor firm or proprietary concern, as the case may be, shall be deemed to be the loss or as the case may be, allowance for depreciation of the successor company for the previous year in which business reorganisation was effected and the other provisions of the Act relating to set off and carry forward of loss and allowance for depreciation shall apply accordingly.

■ *When conditions of section 47*(xiii)[1]*/*(xiv)[2] *are not complied* - When conditions of section 47(*xiii*)[1]/(*xiv*)[2] are not complied with, the set off of loss or allowance of depreciation in the hands of the successor company shall be deemed to be the income of the company chargeable to tax in the year in which such conditions are not complied with.

■ *Meaning of "unabsorbed depreciation" and "accumulated loss"* - "Accumulated loss" and "unabsorbed depreciation" means so much of the loss/depreciation of the predecessor firm/proprietary concern (not being speculative business loss) which such firm/concern would have been entitled to carry forward and set off if the business re-organisation had not taken place.

Provisions illustrated - X and Y (1:3) are two partners of X & Co. on March 31, 2008. It has brought forward business loss of Rs. 10 crore which remains due to be set off at the end of seventh year which falls on March 31, 2008. As per section 72, a loss cannot be allowed to be carried forward for more than 8 years. Thus X & Co. has one more year after which the unadjusted accumulated loss will lapse. Now the firm is converted into a company with effect from April 1, 2008. All the assets and liabilities of the firm are taken over by the company. Shares have been allotted to X and Y (1:3) in consideration of transfer of the business of the firm. The brought forward loss of the firm can be set off by the company. The unadjusted loss will get a new lease of life for another 8 years. For this purpose, the brought forward loss shall be treated as loss of the previous year 2008-09 of the company and it can be set off against the income of the previous year 2008-09 and if it is not possible to set off, it can be carried forward up to the previous year 2016-17.

One of the conditions for carry forward of the loss of the firm is that the aggregate of the shareholding in the company of the partners of the firm is not less than 50 per cent of the total voting power in the company and their shareholding continues to be as such for a period of 5 years from the date of the succession.

Suppose the loss of Rs. 10 crore is set off by the company during the previous years 2008-09 and 2009-10 and Y transfers his entire shareholding on May 6, 2010, then Rs. 10 crore will become income of the previous year 2010-11 of the company.

Slump sale

520. To resolve the controversy regarding tax incidence upon sale of an undertaking by way of slump sale, the Finance Act, 1999 inserted sections 2(*42C*) and 50B and amended section 43(*6*).

520.1 ***Definition of slump sale [Sec. 2(42C)]*** - Section 2(*42C*) has been inserted with effect from the assessment year 2000-01. The definition reads as under—

1. *See* para 169.2-18.
2. *See* para 169.2-20.

"Slump sale means the transfer of one or more undertakings as a result of the sale for a lump sum consideration without values being assigned to the individual assets and liabilities in such sales."

In order to come within the purview of the definition, one should satisfy the following conditions—

1. Taxpayer owns an undertaking.

2. He transfers the undertaking by way of sale.

3. The transfer is for lump sum consideration without assigning values to individual assets and liabilities.

520.1-1 *TAXPAYER OWNS AN UNDERTAKING* - Undertaking for this purpose means any part of an undertaking, or a unit or division of an undertaking or a business activity taken as a whole, but does not include individual assets or liabilities or any combination thereof not constituting a business activity.

In other words, a part of undertaking will not be termed as "undertaking" for the purposes of the definition if the assets/liabilities of the specific part of the undertaking cannot by themselves constitute a business activity. Likewise, transfer of assets which excludes a few significant assets without which the business cannot be carried on effectively, may not be considered as a transfer of business.

The transferee of the undertaking (or part thereof) should be able to conduct the business as and when the undertaking is acquired. To come within the purview of "undertaking" it is essential that—

a. the undertaking itself should constitute a business activity as a whole if such undertaking is transferred; or

b. the part of the undertaking should constitute a business activity as a whole if that part of undertaking is transferred; or

c. the unit or division of the undertaking should constitute a business activity as a whole if such unit/division of the undertaking is transferred.

520.1-2 *THE UNDERTAKING IS TRANSFERRED BY WAY OF SALE* - The "undertaking" is transferred by way of sale. A transfer by any other mode (like compulsory acquisition) is not covered by the definition of slump sale under section 2(*42C*).

520.1-3 *TRANSFER TAKES PLACE FOR A LUMP SUM CONSIDERATION* - The transfer takes place for a lump sum consideration without assigning values to individual assets and liabilities. In this regard, the following points should be noted—

1. The determination of the value of an asset or liability for the sole purpose of payment of stamp duty, registration fees or other similar taxes or fees shall not be regarded as assignment of values to individual assets or liabilities.

2. If the values of individual assets are determined for determining the purchase consideration (or where it is possible to identify the price attributable to different assets) (not being the case mentioned at (*1*) *supra*), the transaction would not be regarded as "slump sale" even if the individual values are not mentioned in the agreement—*CIT* v. *Artex Manufacturing Co.* [1997] 227 ITR 260 (SC). To put it differently, if the values of individual assets are determined for arriving at the purchase consideration [not being the case covered by (*1*) (*supra*)] the transaction will not be treated as "slump sale" even if such values are not disclosed in the agreement. Such determination of item-wise values may be regarded as assigning values to individual assets/liabilities.

520.2 ***How to find out written down value in the hands of transferor in the case of slump sale [Sec. 43(6)]*** - The written down value of a block of assets shall be determined as follows :

For the assessment year 2008-09, written down value of a block of assets shall be determined as follows, in the case of slump sale—

Step 1	Find out the depreciated value of the block on the first day of the previous year.
Step 2	To this value add "actual cost" of the asset acquired during the previous year.
Step 3	From the resultant figure, deduct money received/receivable (together with scrap value) in respect of that asset (falling within the block of assets) which is sold, discarded, demolished or destroyed during the previous year.

Notes :—

1. The amount of reduction under *Step 3* cannot exceed the value of assets computed under *Step 1* and *Step 2.*

2. However, in the case of a slump sale, the following shall be reduced from the value determined after *Step 2.*

Actual cost of assets falling in the block transferred by "slump sale"

Less :

a. depreciation actually allowed in respect of that asset in respect of any previous year relevant to the assessment year commencing before 1988-89; and

b. depreciation that would have been allowable from the assessment year 1988-89 onward as if that asset was the only asset in the relevant block of assets.

520.3 ***Capital gains in the case of slump sale [Sec. 50B]*** - The provisions of section 50B, applicable for computation of capital gains in the case of slump sale, are given below—

1. Any profits or gains arising from the slump sale effected in the previous year shall be chargeable as long-term capital gains and shall be deemed to be the income of the previous year in which the transfer took place.

Where, however, any capital asset being one or more undertakings owned and held by the assessee for not more than 36 months is transferred under the slump sale, then capital gain shall be deemed to be short-term capital gain.

2. In the case of slump sale of the capital asset being one or more undertaking, the "net worth" of the undertaking shall be taken as cost of acquisition and cost of improvement. "Net worth" for this purpose is the aggregate value of total assets of the undertaking or division as reduced by the value of liabilities of such undertaking or division as appearing in the books of account. Any change in the value of assets on account of revaluation of assets shall be ignored for the purpose of computing the net worth. The aggregate value of total assets of such undertaking or division shall be the written down value of block of assets determined in accordance with the provisions contained in sub-item (*C*) of section 43(*6*)(*c*)(*i*) in the case of depreciable assets and the book value for all other assets.

3. The benefit of indexation will not be available.

4. If net worth is negative, it is taken as equal to zero and the sale consideration will become capital gains—***Zuari Inds. Ltd.*** v. ***CIT*** [2006] 9 SOT 563 (Mum.).

5. Every assessee, in the case of slump sale, shall furnish along with the return of income, a report of a chartered accountant in Form No. 3CEA indicating the computation of the net worth of the undertaking or division, as the case may be, and certifying that the net worth of the undertaking or division, as the case may be, has been correctly arrived at.

520.4 ***Other points*** - One should also keep in view the following—

1. Revaluation shall be ignored whether it is done during the current year or the earlier years, or whether it is upward revision or downward revision.

2. For computing net worth, the aggregate of total assets shall be—

❑ In the case of depreciable assets	The written down value of block of assets determined in accordance with the provisions contained in sub-item (*C*) of section 43(6)(*c*)(*i*)
❑ In the case of other assets	The book value of such assets

As mentioned earlier, any increase/decrease in book values due to revaluation shall be ignored. From the aggregate of total assets of the undertaking, which is transferred, liabilities of the

undertaking shall be deducted. Nothing is deductible on account of contingent liability as it does not appear in balance sheet.

3. If transfer agreement specifies the individual value of assets to be transferred, then such a transaction is not covered by "slump sale". Consequently, capital gain shall be computed separately.

4. In case of slump sale if the undertaking or part of the undertaking is transferred, the gain (or loss) will be long-term if such undertaking was owned and held for more than 36 months, even if some of the assets in the undertaking are short-term capital asset or even if some of the assets are not "assets" under section 2(*14*) [for instance stock-in-trade forming part of slump sale].

5. In case of slump sale, accumulated loss/depreciation will be carried forward and set off by the transferor (now losses/depreciation can be carried forward even if business is discontinued). In the case of amalgamation/demerger, the transferee can carry forward the losses/depreciation of the transferor by virtue of section 72A.

6. In the case of slump sale, a break up of cost of each asset/liability is not available. Consequently a problem arises as to how to find out "actual cost" of different assets acquired by way of slump sale in the hands of purchaser. No specific provision has been made in section 43(*1*) which defines "actual cost" or section 43(*6*) which defines "written down value". In *CIT* v. *Spunpipe & Construction Co. Ltd.* [1965] 55 ITR 68 (Guj.), it was held that in the case of acquisition of an undertaking as a going concern, the composite consideration can be bifurcated between various assets in a fair and reasonable manner permitted by law. Even Accounting Standard 10 provides that "where several assets are purchased for a consolidated price, the consideration is appropriated to the various assets on a fair basis as determined by competent valuers".

Therefore, a person who acquires an undertaking by way of slump sale can claim depreciation on the basis of fair apportionment of total consideration.

520.5 *Provisions illustrated* - To have better understanding the following problems are given—

520.5-P1 *X Ltd. is engaged in manufacture of chemicals and paper since 1960. Depreciated value of block of asset (depreciation rate : 15 per cent) on April 1, 2008 is Rs. 15,00,000. The company purchases Plant A* (rate of depreciation 15 per cent) on June 15, 2008 for Rs. 4,18,000. It is put to use on the same day. The company sells Plant B (rate of depreciation 15 per cent) on December 16, 2008 for (a) Rs. 11,70,000 (b) Rs. 14,70,000, (c) Rs. 25,70,000. The company transfers paper division by way of slump sale on December 31, 2008 for Rs. 6.60 lakh (expenditure on transfer : Rs. 1.60 lakh). The following information in respect of paper division is noted from the company's records and certified by the chartered accountant of the company in Form 3CEA—*

	Rs.
Actual cost of assets acquired in 1986-87	*6,40,000*
Depreciation claimed under the Income-tax Act up to the assessment year 1988-89	*60,000*
Depreciation that would have been allowable for the assessment years 1989-90 to 2008-09 as if the asset was the only asset in the relevant block	*90,000*

Find out the amount of depreciation and capital gain chargeable to tax for the assessment year 2009-10.

SOLUTION :

	If Plant B is transferred for		
	Rs. 11.70 lakh Rs.	Rs. 14.70 lakh Rs.	Rs. 25.70 lakh Rs.
Depreciated value of the block of assets on April 1, 2008	15,00,000	15,00,000	15,00,000
Add : Actual cost of Plant A acquired during the previous year	+4,18,000	+4,18,000	+4,18,000
Less : Sale proceeds of Plant B (*it cannot exceed Rs. 15 lakh + Rs. 4.18 lakh)	(-)11,70,000	(-)14,70,000	(-)19,18,000*
Balance (a)	7,48,000	4,48,000	*Nil*

*Plant A is not qualified for additional depreciation.

	If Plant B is transferred for		
	Rs. 11.70 lakh Rs.	**Rs. 14.70 lakh Rs.**	**Rs. 25.70 lakh Rs.**
Less : Actual cost *minus* depreciation of assets of paper division transferred by way of slump sale [*i.e.*, Rs. 6,40,000– Rs. 60,000 – Rs. 90,000 = Rs. 4,90,000; it cannot however exceed (a)] (b)	4,90,000	4,48,000	*Nil*
Written down value of the block on March 31, 2009	2,58,000	*Nil*	*Nil*
Depreciation for the previous year 2008-09 @ 15%	38,700	*Nil*	*Nil*
Depreciated value of the block on April 1, 2009	2,19,300	*Nil*	*Nil*
Capital gain on transfer of Plant B as per section 50			
Sale consideration of Plant B	Not applicable	Not applicable	25,70,000
Less : Cost of acquisition as per section 50 (*i.e.*, Rs. 15 lakh + Rs. 4.18 lakh)	-	-	19,18,000
Short-term capital gain	-	-	6,52,000
Capital gain on transfer of depreciable assets of paper division			
Sale proceeds	6,60,000	6,60,000	6,60,000
Less : Cost of acquisition and cost of improvement [being the net worth mentioned at (b)] (benefit of indexation is not available)	4,90,000	4,48,000	*Nil*
Expenses on transfer	1,60,000	1,60,000	1,60,000
Long-term capital gains	10,000	52,000	5,00,000

520.5-P2 *X Ltd. is engaged in manufacture of chemical (since 1960) and paper (since 2004). The following data is noted from the balance sheet of X Ltd. as on March 31, 2008—*

	(Rs. in thousand)
Equity share capital	*60,00*
Preference share capital	*10,00*
General reserve	*40,00*
Revaluation reserve	*6,00*
Share premium	*8,00*
Total	*1,24,00*

(Rs. in thousand)

	Chemical division	**Paper division**	**Total**
Land	*30,00*	*20,00*	*50,00*
Plant and machinery	*16,00*	*36,00*	*52,00*
Stock	*5,00*	*9,00*	*14,00*
Debtors and other current assets	*4,00*	*11,00*	*15,00*
Less : *Creditors*	*4,00*	*3,00*	*7,00*
Total	*51,00*	*73,00*	*1,24,00*

Revaluation reserve was created by making upward revision of land belonging to chemical division (Rs. 1 lakh) and paper divisions (Rs. 5 lakh). The company wants to transfer paper division on April 1, 2008 by way of slump sale for a total consideration of Rs. 78 lakh (transfer expenses being Rs. 28,000). By taking into consideration the following additional information, find out the amount of capital gains and other tax consequences.

1. Transfer agreement does not specify value of individual assets/liabilities. However, the value of land of paper division for the purpose of stamp duty is Rs. 46 lakh. The same amount is adopted by the stamp valuation authority of the MP Government.

2. *The rate of depreciation on plant and machinery owned by X Ltd. is 15 per cent†. The depreciated value of the block (consisting of chemical division and paper division) on April 1, 2008 is Rs. 70 lakh for income-tax purpose. Apart from transferring plant and machinery of paper division, the company purchases an old Plant P for Rs. 1 lakh and sells Plant Q for Rs. 20 lakh (situation 1) or Rs. 50 lakh (situation 2) in September 2008. Plant P and Q belong to chemical division.*

Plant and machinery (old) of the paper division was purchased in May 2004 for Rs. 95 lakh. The division started commercial production in June 2004. However, one of the plant (cost Rs. 10 lakh) was put to use in March 2005. No other asset for paper division is purchased/sold between May 2003 and March 2008.

SOLUTION : X Ltd. transfers paper division for a lump sum consideration. Transfer satisfies all conditions of section 2(42C). Paper division was set up in 2004 and it is transferred on April 1, 2008. The capital gain (or loss) will be long-term. The sale consideration is Rs. 78 lakh. The cost of acquisition is net worth of paper division which will be determined as follows—

Computation of written down value for the purpose of computing depreciation

	Situation 1 Rs.	Situation 2 Rs.
Depreciated value of the block of assets of chemical and paper divisions on April 1, 2008	70,00,000	70,00,000
Add : Cost of Plant P	(+) 1,00,000	(+) 1,00,000
Less : Sale proceeds of Plant Q	(–) 20,00,000	(–) 50,00,000
Balance (a)	51,00,000	21,00,000
Less : Depreciated value of assets of paper division, it cannot exceed (a) [see Note]	(–) 44,52,406	(–) 21,00,000
Written down value	6,47,594	*Nil*
Less : Depreciation available to X Ltd. for the previous year 2008-09	97,140	*Nil*

Note - Computation of depreciated value of assets of paper division (as if paper division only paper division) is owned by X Ltd.—

Depreciated value on April 1, 2004	*Nil*
Add : Cost of assets acquired and put to use during 2004-05	95,00,000
Written down value on March 31, 2005	95,00,000
Less : Depreciation for 2004-05 (25% of Rs. 85 lakh + 12.5% of Rs. 10 lakh)	22,50,000
Depreciated value on April 1, 2005	72,50,000
Less : Depreciation for 2005-06	10,87,500
Depreciated value on April 1, 2006	61,62,500
Less : Depreciation for 2006-07	9,24,375
Depreciated value on April 1, 2007	52,38,125
Less : Depreciation for 2007-08	7,85,719
Depreciated value on April 1, 2008	44,52,406

Computation of net worth of paper division

	Situation 1 Rs.	Situation 2 Rs.
Land (excluding Rs. 5 lakh which was added by revaluation)	15,00,000	15,00,000
Plant and machinery (i.e., amount considered while computing written down value)	44,52,406	21,00,000
Stock	9,00,000	9,00,000

†25 per cent upto the assessment year 2005-06.

	Situation 1 Rs.	Situation 2 Rs.
Debtors and other current assets	11,00,000	11,00,000
Total	79,52,406	56,00,000
Less : Creditors	3,00,000	3,00,000
Net worth	76,52,406	53,00,000
Computation of capital gain on transfer of paper division		
Sale consideration	78,00,000	78,00,000
Less : Cost of acquisition (being net worth, indexation benefit is not available)	76,52,406	53,00,000
Expenses on transfer	28,000	28,000
Long-term capital gain	1,19,594	24,72,000

520.6 ***Amalgamation/Demerger*** **vis-a-vis** ***slump sale*** - The chief points of distinction between amalgamation/demerger and slump sale are as follows :

- The payment of a lump sum sale consideration is required in respect of transfer of an undertaking by slump sale. In demerger the resulting company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis. Likewise, in the case of amalgamation, the amalgamated company will issue its shares to the shareholders of the amalgamating companies.
- In a slump sale, values are not assigned to individual assets (and liabilities) of the undertaking whereas in the case of amalgamation and demerger, the assets and liabilities of the amalgamating company/demerged company are transferred at the values appearing in the books of account immediately before the merger/demerger to the amalgamated company/resulting company.
- The provisions pertaining to amalgamation and demerger are applicable to only companies. The provisions pertaining to slump sale apply to all the assessees and are not limited to companies.

Transfer of assets between holding and subsidiary companies

521. The following special provisions are applicable—

521.1 ***When a capital asset (other than block of asset) is transferred [Expln. 6 to sec. 43(1)]*** - Where a parent company transfers a capital asset to its 100 per cent subsidiary company or *vice versa*, the actual cost of the asset transferred to the transferee- company will be taken to be the same as it would have been if the transferor-company had continued to hold the capital asset for the purpose of its business provided that the transferee-company is an Indian company.

521.2 ***When a block of asset is transferred [Expln. 2 to sec. 43(6)]*** - The aforesaid rule is not applicable if a block of asset is transferred. Where in any previous year, any block of assets is transferred by a holding company to its wholly owned subsidiary company or *vice versa*, then actual cost of block of assets in the case of transferee-company shall be written down value of block of assets of the transferor-company for the immediately preceding previous year as reduced by the depreciation actually allowed in relation to the said preceding previous year. This rule is, however, applicable only if the transferee-company is an Indian company.

521.3 ***Exemption under section 47*** - The following are not treated as transfer—

a. any transfer of a capital asset by a company to its wholly owned Indian subsidiary company [sec. 47(*iv*)]; and

b. any transfer of a capital asset by a wholly owned subsidiary company to its Indian holding company [sec. 47(*v*)].

■ The following points should be noted—

1. Provisions under section 47(*iv*)/(*v*) are not applicable in the case of transfer of a capital asset made after February 29, 1988 as stock-in-trade.

2. Section 47(*iv*) and (*v*) covers only the immediate subsidiary company of the holding company. There is no justification for transplanting the definition of 'holding company' under the Companies Act into the provisions of section 47 automatically—*Kalindi Investment (P.) Ltd.* v. *CIT* [2002] 120 Taxman 896 (Guj.).

521.4 ***Withdrawal of exemption given by section 47(iv)/(v) [Secs. 47A, 49(3) and proviso to sec. 47(iv), (v)]*** - Any transfer of capital asset by a company to its wholly owned Indian subsidiary company or by a wholly owned subsidiary company to its Indian holding company is not treated as transfer by virtue of section 47(*iv*)/(*v*).

521.4-1 *CASES WHEN EXEMPTION IS TAKEN BACK* - In the following two cases (*i.e. 1* and *2*), the above exemption shall be withdrawn and in the last case (*i.e., 3*) the exemption is not available —

1. If at any time before the expiry of eight years from the date of transfer of a capital asset between holding company and its wholly owned subsidiary company, such capital asset is converted by the transferee-company into (or is treated by it as) stock-in-trade of its business.

2. The holding company ceases to hold the whole of the share capital of the subsidiary company before the expiry of the period of eight years aforesaid.

3. The holding/subsidiary company transfers a capital asset as stock-in-trade after February 29, 1988. In such a case the transfer shall be regarded as "transfer" and will be taxed according to normal provisions of capital gains.

521.4-2 *CONSEQUENCES* - In the above noted two cases (*i.e., 1* and *2*), transfer of capital asset between holding and subsidiary company is chargeable to tax by virtue of section 47A. In such a case cost of acquisition in the hands of the transferee-company will be the cost for which the asset was acquired by it.

H Ltd. is 100 per cent holding company of S Ltd., an Indian company. S Ltd. acquires a depreciable asset from H Ltd. on April 1, 2007 at market value of Rs. 120 crore. Written down value of the block of assets in the hands of H Ltd. on March 31, 2007 is Rs. 80 crore. As this is transfer between holding company and its 100 per cent subsidiary company, capital gain is not taxable in the hands of H Ltd. by virtue of section 47(*iv*). When capital gain is exempt under section 47(*iv*), written down value in the hands of S Ltd. for claiming depreciation will be Rs. 80 crore.

On May 10, 2008, H Ltd. transfers 10 per cent of its holding in S Ltd. for a specified consideration to an outsider. As the relationship 100 per cent holding company and subsidiary company is discontinued within 8 years from April 1, 2007, by virtue of section 47A, exemption provided to H Ltd. shall be withdrawn and short term capital gain will be taxable in the hands of H Ltd. When exemption is withdrawn, depreciation can be claimed by S Ltd. on purchase price of Rs. 120 crore with effect from date of acquisition, *i.e.*, April 1, 2007, although the event which is responsible for withdrawal of exemption (*i.e.*, transfer of shareholding in S Ltd. by H Ltd. to an outsider) takes place in the next year—***Essar Oil Ltd.*** v. ***CIT*** [2007] 13 SOT 691 (Mum.) and depreciation (in the case of block of assets) will be available to the transferee-company at the cost for which the assets were acquired.

521.4-2P1 *S Ltd. is a wholly owned subsidiary of A Ltd. (both are Indian companies and maintain books of account on the basis of financial year). On April 10, 1984 (relevant to the assessment year 1985-86), S Ltd. transfers a capital asset (i.e., shares) to A Ltd. (acquired on April 6, 1981 for Rs. 50,000) for Rs. 1,50,000. A Ltd. sells the asset on May 10, 2008 for Rs. 3,40,000. Determine the assessable profits of A Ltd. and S Ltd. under the following situations :*

1. Before the sale of asset, A Ltd. has not converted it into stock-in-trade and it does not cease to hold entire share capital of S Ltd.

2. *A Ltd. has converted the capital asset into stock-in-trade before its sale on May 10, 2008 (date of conversion : June 10,1987, fair market value : Rs. 3,10,000).*

3. *Though A Ltd. does not convert capital asset into stock-in-trade, it ceases to hold entire share capital of S Ltd. on June 10,1988 when 5 per cent shareholding in S Ltd. is transferred by way of sale to the public.*

SOLUTION : *Under situation (1),* transfer between A Ltd. and S Ltd. will not be treated as transfer under section 47(v). Consequently, nothing will be taxable in the hands of S Ltd. A Ltd. will, however, be taxable in respect of capital gain computed as under :

	Rs.
Sale consideration	3,40,000
Less : Indexed cost of acquisition (*i.e.,* Rs. 50,000 × 582 ÷ 125*)	2,32,800
	1,07,200

*Cost inflation index for the year (1984-85) in which the asset was first held by A Ltd. In other words, indexation will start only from 1984-85 in this case.

Under situation (2), the chargeable profit will be determined as under :

❑ *S Ltd.* : Since A Ltd. has converted the capital asset into stock-in-trade within eight years from April 10,1984, exemption granted by section 47(v) will not be available and, consequently, Rs. 1,00,000† (*i.e.,* Rs. 1,50,000 — Rs. 50,000) will be treated as long-term capital gain (by virtue of section 47A) of S Ltd. for the assessment year 1985-86.

If the assessment of S Ltd. is completed, the Assessing Officer has power to reopen the assessment for this purpose under section 155(7B) at any time before 4 years from the end of the previous year in which the capital asset is converted into stock-in trade (*i.e.,* up to March 31,1992).

❑ *A Ltd.* : Rs. 30,000 (*i.e.,* Rs. 3,40,000 — Rs. 3,10,000) will be chargeable to tax under section 28(*i*) as business profits for the assessment year 2008-09. Besides, capital gain will be determined as under :

	Rs.
Full value of consideration received [fair market value on the date of conversion of capital stock into stock-in-trade under section 45(2)]	3,10,000
Less : Indexed cost of acquisition (Rs. 1,50,000 × 150 ÷ 125)	1,80,000
Long-term capital gain for the assessment year 2009-10	1,30,000

Under situation (3), the chargeable profit will be determined as under :

❑ *S Ltd.* : Since A Ltd. has transferred shareholding in S Ltd. before the expiry of 8 years from April 10,1984, the exemption granted by section 47(v) will not be available and, consequently, Rs. 1,00,000† (*i.e.,* Rs. 1,50,000 *minus* Rs. 50,000) will be treated as long-term capital gain by virtue of section 47A for the assessment year 1985-86. If assessment of S Ltd. is completed, the Assessing Officer has power to reopen the assessment under section 155(7B) at any time up to March 31,1993 (*i.e.,* up to 4 years from the end of the previous year in which shareholding is transferred).

❑ *A Ltd.* : Capital gain will be determined as under :

	Rs.
Sale consideration	3,40,000
Less : Indexed cost of acquisition (*i.e.,* Rs. 1,50,000 × 582 ÷ 125*)	6,98,400
Long-term capital gain	(–) 3,58,400

*Cost inflation index for the year (1984-85) in which the asset was first held by A Ltd. In other words, indexation will be started only from 1984-85 in this case.

521.5 ***Provisions illustrated*** - To have better understanding the following problems are given—

†Long-term capital gain is computed by deducting indexed cost of acquisition only from the assessment year 1993-94 onwards.

521.5-P1 *S Ltd. is a wholly-owned subsidiary of H Ltd. On April 22, 1987, it transfers the following assets to H Ltd.*

Block of assets	Rate of depreciation from the assessment year 1988-89	Written down value for the assessment year 1987-88 Rs.	Depreciation for assessment year 1987-88 Rs.	Agreed consideration Rs.
Plant	*50%*	*9,50,000*	*1,42,500*	*6,30,000*
Building	*10%*	*20,00,000*	*1,00,000*	*27,10,000*

What is the actual cost of assets to H Ltd. ?

SOLUTION : In the case of H Ltd. actual cost of block of assets would be as follows :

	Plant Rs.	Building Rs.
Written down value for the assessment year 1987-88	9,50,000	20,00,000
Less : Depreciation for the assessment year 1987-88	1,42,500	1,00,000
Actual cost of asset to H Ltd.		
❑ if it is an Indian company	8,07,500	19,00,000
❑ if it is a foreign company	6,30,000	27,10,000

521.5-P2 *H Ltd. owns the following asset on April 1, 2008 :*

Block of asset	Rate of depreciation	Written down value on April 1, 2008
Plant (consisting of Plants A, B and C)	*15%*	*20,50,000*

On June 30, 2008, it sells Plant A for Rs. 6,00,000. It, however, acquires Plant D for Rs. 15,00,000 on March 10, 2009. On April 16, 2009, Plants B, C and D are transferred by it to S Ltd. (a wholly-owned subsidiary of H Ltd.) for Rs. 3,50,000 or for Rs. 60,00,000. S Ltd. owns Plant P whose written down value on April 1, 2009 is Rs. 2,00,000; besides it purchases plant Q on May 10, 2009 for Rs. 1,00,000, in either case the rate of depreciation is 15 per cent and new acquisition are not eligible for additional depreciation. Find out the tax consequences if S Ltd. is an Indian company or foreign company. Additional depreciation is not available.

SOLUTION :

H Ltd.	*Block 1 (Plant)* Rs.
Depreciated value of the block on April 1, 2008	20,50,000
Add : Actual cost of Plant D acquired on March 10, 2009	15,00,000
Less : Money payable in respect of Plant A sold during 2008-09	(-) 6,00,000
Written down value on March 31, 2009	29,50,000
Less : Depreciation for the previous year 2008-09	3,30,000
Depreciated value of the block on April 1, 2009	26,20,000

(Rs. in lakh)

	If S Ltd. is an Indian company		If S Ltd. is a foreign company	
	If the block is transferred for		If the block is transferred for	
	Rs. 3.50 lakh	Rs. 60 lakh	Rs. 3.50 lakh	Rs. 60 lakh
Depreciated value of the block consisting of Plants B, C and D on April 1, 2009	26.20	26.20	26.20	26.20
Less: Sale proceeds of Plants B, C and D transferred to S Ltd. (*cannot exceed the opening balance)	3.50	26.20*	3.50	26.20*

	If S Ltd. is an Indian company		If S Ltd. is a foreign company	
	If the block is transferred for		If the block is transferred for	
	Rs. 3.50 lakh	Rs. 60 lakh	Rs. 3.50 lakh	Rs. 60 lakh
Written down value on March 31, 2010	20.70	*Nil*	22.70	*Nil*
Depreciation for the previous year 2009-10 (no depreciation is available as the block ceases to exist)	*Nil*	*Nil*	*Nil*	*Nil*
Capital gains				
Sale proceeds	3.50	60	3.50	60
Less: Cost of acquisition as per section 50	26.20	26.20	26.20	26.20
Short-term capital gain [* by virtue of section 47(iv), it is exempt from tax]	*Nil**	*Nil**	(-) 22.70	33.80
S Ltd.				
Depreciated value of the block consisting of Plant P on April 1, 2009	2	2	2	2
Add: Actual cost of Q acquired during 2009-10	1	1	1	1
Add : Actual cost of Plants B, C and D acquired from H Ltd.	26.20	26.20	3.50	60
Written down value of the block consisting of Plants B, C, D, P and Q on March 31, 2010	29.20	29.20	6.5	63
Depreciation for 2009-10	4.38	4.38	0.975	9.45

The following points should be noted—

1. The rule given by the fifth proviso to section 32(1) [see para 109.7-2d] is not applicable in the case of a transfer between holding company and its hundred per cent subsidiary company.

2. In the above problem if Plant B, C, D or Q is put to use for less than 180 days, then S Ltd. will be entitled for one half of the normal depreciation.

521.5-P3 *S Ltd. is one hundred per cent subsidiary company of H Ltd. S Ltd. owns Plants A and B (depreciation rate 30 per cent, depreciated value of the block Rs. 3,00,000 on April 1, 2008). Plant B was purchased and put to use on November 10, 2006 (cost being Rs. 70,000). Plant B is transferred by S Ltd. to H Ltd. on December 14, 2008 for (a) Rs. 8,000, (b) Rs. 2,70,000, (c) Rs. 4,10,000. It is put to use by H Ltd. on the same day. H Ltd. owns Plant C on April 1, 2008 (depreciation rate 30 per cent, depreciated value; Rs. 60,000). Find out the tax consequences if H Ltd. is an Indian company or if H Ltd. is a foreign company.*

SOLUTION :

(Rs. in thousand)

S Ltd.	If H Ltd. is an Indian company			If H Ltd. is a foreign company		
	Situation (a)	Situation (b)	Situation (c)	Situation (a)	Situation (b)	Situation (c)
Depreciated value of Plants A and B on April 1, 2008	300	300	300	300	300	300
Less : Money payable in respect of Plant B transferred to H Ltd. [see Note 1]	8	270	410	8	270	410
Written down value of the block on March 31, 2009	292	30	*Nil*	292	30	*Nil*
Depreciation for the block for the previous year 2008-09	87.6	9	*Nil*	87.6	9	*Nil*
Capital gains in case of S Ltd.						
Sale proceeds of Plant B	8	270	410	8	270	410

	If H Ltd. is an Indian company			*If H Ltd. is a foreign company*		
S Ltd.	*Situation (a)*	*Situation (b)*	*Situation (c)*	*Situation (a)*	*Situation (b)*	*Situation (c)*
Less : Cost of acquisition as per section 50	NA	NA	300	NA	NA	300
Short-term capital gain [*exempt by virtue of section 47(v)] [see Note 2]	NA	NA	*Nil**	NA	NA	110
H Ltd.						
Depreciated value of the block on April 1, 2008	60	60	60	60	60	60
Add : Actual cost of Plant B acquired from S Ltd. (see Note 3)	41.65	41.65	41.65	8	270	410
Written down value of the block on March 31, 2009	101.65	101.65	101.65	68	330	470
Depreciation						
- on Plant B @ ½ of 30%	6.25	6.25	6.25	1.2	40.5	61.5
- other asset @ 30%	18	18	18	18	18	18

Notes—

1. If the transferee-company, *i.e.*, H Ltd. is an Indian company, then "actual cost" shall be Rs. 41,650 [as is shown in Note 3]. However, in the hands of transferor, *i.e.*, S Ltd. "money payable" by H Ltd. shall be deducted from the block of asset (it is incorrect to deduct Rs. 41,650). Consequently, in Situations (b) and (c), quantum of depreciation available to S Ltd. will be quite low. It is advisable that in such transactions the sale consideration should be fixed keeping in view, the effect of it on the quantum of depreciation available in future.

2. In situations (a) and (b), section 50 is not applicable [see para 173.1-3].

3. Actual cost of Plant B in the hands of H Ltd. if it is an Indian company.

	Rs.
Actual cost of Plant B in the hands of S Ltd. on November 10, 2006	70,000
Less : Depreciation for the previous year 2006-07 (1/2 of 30% of Rs. 70,000)	10,500
Balance on April 1, 2007	59,500
Less : Depreciation for the previous year 2007-08	17,850
Balance on April 1, 2008	41,650

Amalgamation or demerger of co-operative banks (applicable from the assessment year 2008-09 onwards)

522. The following provisions have been inserted by the Finance Act, 2007 in respect of amalgamation or demerger of co-operative banks—

522.1 ***Transfer of capital assets in amalgamation/demerger of co-operative banks - When not treated as transfer*** - By virtue of section 47, the following shall not be treated as transfer with effect from the assessment year 2008-09—

522.1-1 ***TRANSFER OF CAPITAL ASSETS TO AMALGAMATED CO-OPERATIVE BANKS OR RESULTING CO-OPERATIVE BANKS [SEC. 47(1)(vica)]*** - Any transfer of a capital assets in amalgamation/demerger of co-operative banks to amalgamated co-operative bank/resulting co-operative bank shall not be treated as transfer from the assessment year 2008-09 if amalgamation/demerger satisfied the conditions given under section 44DB [for section 44DB, refer to para 522.3].

522.1-2 ***ALLOTMENT OF SHARES IN AMALGAMATED CO-OPERATIVE BANK/RESULTING CO-OPERATIVE BANK TO THE SHAREHOLDERS OF AMALGAMATING/DEMERGED CO-OPERATIVE BANK [SEC. 47(1)(vicb)]*** - Any transfer by a shareholder in a scheme of amalgamation/demerger of co-operative banks of shares held by

him in the amalgamating/demerged co-operative bank shall not be regarded as transfer. This rule is applicable if—

a. transfer is made in consideration of allotment to him of shares in the amalgamated/resulting co-operative bank; and

b. amalgamation/demerger satisfies the conditions of section 44DB.

Actual cost of shares - According to section 49(1), in the aforesaid cases, the cost of shares of the amalgamated/resulting co-operative bank shall be cost of shares of the amalgamating/demerged co-operative banks.

Provisions illustrated - X co-operative bank takes over the business of Y co-operative bank in a scheme of amalgamation of the two banks which satisfies the requirement of section 44DB. Z has purchased 100 shares in Y co-operative bank in 1996 for Rs. 70 per share. As per the scheme of amalgamation, he gets 50 shares in X co-operative bank in lieu of 100 shares in Y co-operative bank. Consequently, the cost of shares in X co-operative bank will be taken as Rs. 140 per share [*i.e.*, Rs. 7,000, being cost of 100 shares in Y co-operative bank ÷ 50 shares in X co-operative bank].

■ The following points should be noted in this regard—

1. To find out whether or not shares in the amalgamated/resulting co-operative bank are long-term capital asset or not, the period of holding shall be determined from date of allotment of shares in the amalgamated/resulting co-operative bank.

2. The indexation will start from the date of allotment of shares in the amalgamated/resulting co-operative bank.

3. If besides shares in the amalgamated/resulting co-operative bank, the shareholders of amalgamating/demerged co-operative bank are allotted something more, say bonds or cash, etc., in consideration of transfer of their shares in the amalgamating/demerged co-operative bank, then the shareholders cannot get the benefit under section 47(*vicb*).

522.2 ***Carry forward and set-off of loss and depreciation - When permissible in the hands of amalgamated/resulting co-operative bank [Sec. 72AB]*** - The successor co-operative bank can set off and carry forward loss and depreciation allowance of the predecessor co-operative bank if a few conditions are satisfied—

1. The predecessor has been engaged in the business of banking, in which the accumulated loss occurred, for three or more years.

2. The predecessor has held at least 3/4 of the book value of fixed assets as on the date of the business reorganization, continuously for 2 years prior to the date of business reorganization.

3. The successor holds at least 3/4 of the book value of fixed assets of the predecessor acquired through business reorganization, continuously for a minimum period of 5 years immediately succeeding the date of business reorganization.

4. The successor continues the business of the predecessor for a minimum period of 5 years from the date of business reorganization.

5. The successor fulfils such other conditions as may be prescribed.

For this purpose, successor co-operative bank is amalgamated/resulting co-operative bank and predecessor co-operative bank is amalgamating/demerged co-operative bank. The expressions "amalgamation" and "demerger" have the same meaning which is given under section 44DB.

522.3 ***Special provision for computing deductions in the case of business reorganization of co-operative banks [Sec. 44DB]*** - Section 44DB has been inserted with effect from the assessment year 2008-09. It is applicable for the purpose of calculating amount of deduction under sections 32, 35D, 35DD and 35DDA if there is a reorganization of business involving amalgamation or demerger of a co-operative bank.

522.3-1 *IN THE YEAR IN WHICH AMALGAMATION OR DEMERGER TAKES PLACE* - In the year in which change of ownership takes place because of the aforesaid reasons, deduction under sections 32, 35D, 35DD and 35DDA shall be calculated as under—

1. Find out the amount of deduction under the aforesaid sections of the previous year in which ownership of assets changes because of the aforesaid reasons on the assumption that the amalgamation or demerger has not taken place.

2. The amount of deduction so determined shall be apportioned between the (*a*) amalgamating co-operative bank and amalgamated co-operative bank, or (*b*) demerged co-operative bank and resulting co-operative bank, as the case may be, in the ratio of number of days for which the assets are used by them during the previous year in which ownership changes.

Provisions illustrated - Business of co-operative bank X has been taken over in a scheme of amalgamation by co-operative bank Y on July 7, 2009. X owns a block of assets (consisting of plants A and B, depreciation rate 15 per cent). On April 1, 2009, depreciated value of the block is Rs. 10,40,000. On July 7, 2009, the block of assets is transferred by X to Y Rs. 30,70,000.

On April 1, 2009, Y owns plant C and D (depreciated value on April 1, 2009 being Rs. 4,00,000)

The following assets are purchased by X and Y during the previous year 2009-10—

Plant P on April 1, 2009 by X for Rs. 7,00,000 (put to use on the same day).

Plant Q on January 10, 2010 by Y for Rs. 3,00,000 (put to use on the same day).

	Rs.
Computation of depreciation allowance on Plants A, B and P	
Depreciated value of the block on April 1, 2009	10,40,000
Add: Actual cost of plant P	7,00,000
Written down value of the block if there is no change in ownership	17,40,000
Depreciation @ 15%	2,61,000
Apportionment between X and Y	
Number of days when the assets are held by X (from April 1, 2009 to July 6, 2009)	97 days
Number of days when assets are held by Y (365 days – 97 days)	268 days
Depreciation on plants A, B and P available to X (Rs. 2,61,000 × 97 ÷ 365)	69,362
Depreciation available on plants A, B and P to Y (Rs. 2,61,000 × 268 ÷ 365)	1,91,638
Computation of depreciation in the hands of Y	
Depreciated value of the block consisting of plants C and D	4,00,000
Add: Actual cost of plants A, B and P taken over from X [on the assumption that *Explanation* 3 to section 43(1) is not applicable]	30,70,000
Add : Actual cost of plant Q	3,00,000
Written down value	37,70,000
Depreciation—	
Plants A, B and P taken over from X	1,91,638
Plant Q (1/2 of 15% of Rs. 3,00,000)	22,500
Plants C and D (15% of Rs. 4,00,000)	60,000
Total depreciation	2,74,138
Depreciated value of block on April 1, 2010	34,95,862

Note - There is no capital gain in the hands of Y, as there is no "transfer" under clause (*vica*)/(*vicb*) in section 47.

522.3-2 ***IN SUBSEQUENT YEARS*** - The provisions of sections 35D, 35DD and 35DDA shall, in a case where an undertaking of the amalgamating/demerged co-operative bank entitled to the deduction under that section is transferred before the expiry of the period specified in that section to amalgamated/resulting co-operative bank, apply to the successor in the financial years subsequent to the year of business reorganization as they would have applied to the predecessor, if the business reorganization had not taken place.

522.3-3 *MEANING OF AMALGAMATION/DEMERGER* - For the aforesaid purpose, meaning of amalgamation/demerger is as follows—

■ *Amalgamation of co-operative banks* - It means the merger of an amalgamating co-operative bank or banks with an amalgamated co-operative bank, which satisfies the following conditions—

1. All the assets and liabilities of the amalgamating co-operative bank immediately before the merger become the assets and liabilities of the amalgamated co-operative bank. This rule is, however, not applicable in the case of the assets transferred, by sale or distribution on winding up, to the amalgamated co-operative bank.

2. The members holding 75 per cent or more voting rights in the amalgamating co-operative bank become members of the amalgamated co-operative bank.

3. The shareholders holding 75 per cent or more in value of the shares in the amalgamating co-operative bank (other than the shares held by the amalgamated co-operative bank or its nominee or its subsidiary, immediately before the merger) become shareholders of the amalgamated co-operative bank.

■ *Demerger of co-operative banks* - It means the transfer by a demerged co-operative bank of one or more of its undertakings to any resulting co-operative bank, which satisfies the following conditions—

1. All the assets and liabilities of the undertaking immediately before the transfer become the assets and liabilities of the resulting co-operative bank.

2. The assets and the liabilities are transferred to the resulting co-operative bank at values (other than change in the value of assets consequent to their revaluation) appearing in its books of account immediately before the transfer.

3. The resulting co-operative bank issues, in consideration of the transfer, its membership to the members of the demerged co-operative bank on a proportionate basis;

4. The shareholders holding 75 per cent or more in value of the shares in the demerged co-operative bank (other than shares already held by the resulting bank or its nominee or its subsidiary immediately before the transfer), become shareholders of the resulting co-operative bank, otherwise than as a result of the acquisition of the assets of the demerged co-operative bank or any undertaking thereof by the resulting co-operative bank.

5. The transfer of the undertaking is on a going concern basis.

6. The transfer is in accordance with the conditions specified by the Central Government having regard to the necessity to ensure that the transfer is for genuine business purposes.

CHAPTER THIRTY-THREE

Tax planning

Tax planning

525. Over the last eight decades, since the introduction of income-tax, it has been observed that there is a constant struggle between taxpayers and tax collectors, the former trying to reduce (if not negate) their tax liability, and the latter seriously struggling to plug in the loopholes in the statute.

525.1 ***Tax planning/avoidance/evasion - Concept in brief*** - To understand the meaning of tax planning, tax avoidance and tax evasion, one can go through the following cases—

Case 1 - X is an individual. For the assessment year 2009-10, his gross total income is Rs. 3,40,000. Tax on Rs. 3,40,000 is Rs. 23,690. To reduce his tax liability, he deposits Rs. 50,000 in public provident fund account. Consequently, his taxable income and tax liability thereof will be reduced to Rs. 2,90,000 and Rs. 14,420 respectively.

As the tax liability has been reduced within the legal framework, it is tax planning.

Case 2 - X Ltd. is a chemical manufacturing company. It has a factory in Haryana near Delhi border. Within the factory campus a piece of land of 2000 square metre is lying unutilized. The company wants to start a new unit to manufacture computer components. If this manufacturing unit is started in the existing factory campus, deduction under section 80-IB is not available. However, if the new unit is started in Jammu & Kashmir, the company can claim deduction under section 80-IB. To get the benefit of deduction under section 80-IB, the company starts the new unit in a village near Jammu.

The company has two options. Under one of the options, deduction under section 80-IB is not available. However, this deduction is available under the other option. To get the benefit of deduction under section 80-IB, the new unit has been started in Jammu & Kashmir. As the tax liability has been reduced to get the benefit of deduction available under the income-tax, it is tax planning.

Case 3 - Suppose in *Case 2*, the process of manufacturing actually takes place in Haryana. To get the benefit of deduction under section 80-IB, the company takes a factory building on rent in a village in Jammu and only on paper it is shown that the new manufacturing unit is situated in a village near Jammu.

As the company wants to reduce the tax liability by making incorrect statement about the location of manufacturing process, it is tax evasion.

Case 4 - If a sum of money is gifted by a husband to his wife, income generated therefrom is taxable in the hands of husband under the clubbing provisions of section 64(1). Section 64(1) is not applicable if gift is made by the same person out of the funds of his Hindu undivided family in capacity as karta of the family.

If gift is made by karta of the family to his wife, clubbing provisions can be avoided and ultimate tax liability will be reduced. However, the tax liability will be reduced by taking the help of a loophole in the law but within the legal framework. It is tax avoidance.

525.2 ***What is tax planning*** - Tax planning can be defined as an arrangement of one's financial and economic affairs by taking complete legitimate benefit of all deductions, exemptions, allowances and rebates so that tax liability reduces to minimum. Essential features of tax planning are as under —

- It comprises arrangements by which tax laws are fully complied.
- All legal obligations and transactions (both individually and as a whole) are met.
- Transactions do not take the form of colourable devices (*i.e.*, those devices where statute is followed in strict words but actually spirit behind the statute is marred would be termed as colourable devices).
- There is no intention to deceit the legal spirit behind the tax law.

525.3 ***What is tax avoidance*** - The line of demarcation between tax planning and tax avoidance is very thin and blurred. The English courts about eight decades ago recognized the right of a taxpayer to resort to the legal method of tax avoidance. It is well-settled that it is unconstitutional for the Government to attempt tax collection without the authority of law or legal basis. Similarly, a taxpayer cannot escape tax payment outside the legal framework, as he renders himself liable for prosecution as a tax evader.

Tax avoidance is reducing or negating tax liability in legally permissible ways and has legal sanction. Essential features of tax avoidance are as under —

- Legitimate arrangement of affairs in such a way so as to minimize tax liability.
- Avoidance of tax is not tax evasion and carries no public disgrace with it.
- An act valid in law cannot be treated as fictitious merely on the basis of some underlying motive supposedly resulting in lower payment of tax to authorities.
- There is no element of *mala fide* motive involved in tax avoidance.

Over and over again, the courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Tax avoidance is sound law and certainly not bad morality for any body to so arrange his affairs in such a way that the brunt of taxation is the minimum. This can be done within the legal framework even by taking help of loopholes in the law. If on account of a lacuna in the law or otherwise, the assessee is able to avoid payment of tax within the letter of law, it cannot be said that the action is void because it is intended to save payment of tax. So long as the law exists in its present form, the taxpayer is entitled to take its advantage.

The above meaning of tax avoidance has also now acquired the judicial blessings of the Supreme Court of India in *Union of India* v. *Azadi Bachao Andolan* [2003] 263 ITR 706/132 Taxman 373, which reversed the findings in its earlier judgment in *McDowell & Co. Ltd.* v. *CTO* [1985] 154 ITR 148/122 Taxman 11 as legally incorrect.

If the Court finds that notwithstanding a series of legal steps taken by an assessee, in case the intended legal result has not been achieved, the court might be justified in overlooking the intermediate steps. But it would not be permissible for the court to treat the intervening legal steps as fictitious based upon some hypothetical assessment of the 'real motive' of the assessee. The Court must deal with what is tangible in an objective manner. In other words, an act which is otherwise valid in law cannot be treated as fictitious merely on the basis of some underlying motive supposedly resulting in some economic detriment or prejudice to the national interests. A transaction or arrangement which is perfectly permissible under law and has the effect of reducing the tax burden of the assessee, should not be looked upon with disfavour.

525.4 ***What is tax evasion*** - All methods by which tax liability is illegally avoided are termed as tax evasion. An assessee guilty of tax evasion may be punished under the relevant laws. Tax evasion may involve stating an untrue statement knowingly, submitting misleading documents, suppression of facts, not maintaining proper accounts of income earned (if required under law), omission of material facts on assessment. All such procedures and methods are required by the statute to be abided with but the assessee who dishonestly claims the benefit under the statute before complying with the said abidance by making false statements, would be within the ambit of tax evasion.

A person may plan his finances in such a manner, strictly within the four corners of the taxing statute that his tax liability is minimised or made *nil*. If this is done and as observed strictly in accordance

with and taking advantage of the provisions contained in the Act, by no stretch of imagination can it be said that payment of tax has been evaded for. In the context of payment of tax, 'evasion' necessarily means, 'to try illegally to avoid paying tax'—*CIT* v. *Sri Abhayananda Rath Family Benefit Trust* [2002] 123 Taxman 81 (Ori.).

525.5 ***Tax avoidance*** v. ***Tax evasion*** - The following are the broad areas of distinction between the two :

Tax avoidance	*Tax evasion*
1. Any planning of tax which aims at reducing or negating tax liability in legally recognised permissible ways, can be termed as an instance of tax avoidance.	*1.* All methods by which tax liability is illegally avoided is termed as tax evasion.
2. Tax avoidance takes into account the loopholes of law.	*2.* Tax evasion is an attempt to evade tax liability with the help of unfair means/methods.
3. Tax avoidance is tax hedging within the framework of law.	*3.* Tax evasion is tax omission.
4. Tax avoidance has legal sanction	*4.* Tax evasion is unlawful and an assessee guilty of tax evasion may be punished under the relevant laws.
5. Tax avoidance is intentional tax planning before the actual tax liability arises.	*5.* Tax evasion is intentional attempt to avoid payment of tax after the liability to tax has arisen.

525.6 ***Tax planning*** v. ***Tax management*** - Tax management involves the procedures of compliance with the statutory provisions of law. The following are the broad areas of distinction between tax planning and tax management :

Tax planning	*Tax management*
1. The objective of tax planning is to reduce the tax liability to the minimum.	*1.* The objective of tax management is to comply with the provisions of law.
2. Tax planning is futuristic in its approach.	*2.* Tax management relates to past (*i.e.*, assessment proceedings, rectification, revision, appeals etc.), present (filing of return of income on time on the basis of updated records) and future (corrective action).
3. Tax planning is very wide in its coverage and includes tax management.	*3.* Tax management has a limited scope, *i.e.*, it deals with specific activities such as filing of returns of income on time, drafting appeals, deduction of tax at source on time, updating records from time to time, etc.
4. The benefits arising from tax planning are substantial particularly in the long run.	*4.* As a result of effective tax management, penalty, penal interest, prosecution, etc., can be avoided.

Tax planning with reference to setting up of a new business

526. In the case of setting up of a new business, one has to take the following decisions —

a. where the new undertaking should be located ;

b. what should be manufactured in the new undertaking ; and

c. what should be the legal form of organisation.

526.1 ***Location of new business*** - Many factors affect location of a business. The following tax incentives are available under the Act —

1. Under section 10A in the case of a newly established industrial undertaking in free trade zones [*see* para 39].

2. Under section 10B in the case of a newly established hundred per cent export-oriented undertaking [*see* para 40].

3. Under section 80-IB in the case of newly set up industrial undertaking in an industrially backward State or district [*see* para 254].

526.2 ***Nature of new business*** - Many incentives are available under the Act which are directly co-related to the nature of business. Some of these incentives are as follows —

1. Newly established industrial undertaking in free trade zones [Sec. 10A—*see* para 39].

2. Newly established hundred per cent export-oriented undertakings [Sec. 10B—*see* para 40].

3. Venture capital companies [Sec. 10(*23FB*) - *see* para 38.56A].

4. Infrastructure capital companies [Sec. 10(*23G*) - *see* para 38.57].

5. Tea development account [Sec. 33AB—*see* para 111].

6. Site restoration fund [Sec. 33ABA—*see* para 112].

7. Telecommunication services [Sec. 35ABB - *see* para 117].

8. Reserves for shipping business [Sec. 33AC—*see* para 113].

9. Amortisation of certain preliminary expenses [Sec. 35D—*see* para 121].

10. Deduction for expenditure on prospecting for certain minerals [Sec. 35E—*see* para 122].

11. Deduction for special reserve created by a financial corporation under section 36(1)(*viii*) [*see* para 134].

12. Special provision for deduction in the case of business for prospecting for mineral oil [Secs. 42 and 44BB—*see* paras 162.1 and 162.8].

13. Special provisions for computing profits and gains of business of civil construction [Sec. 44AD—*see* para 162.4].

14. Special provisions in the case of business of plying, hiring or leasing goods carriages [Sec. 44AE—*see* para 162.5].

15. Special provisions for computing profits and gains of retail business [Sec. 44AF—*see* para 162.6].

16. Special provisions in the case of shipping business [Sec. 44B—*see* para 162.7].

17. Special provisions in the case of business of operation of aircraft [Sec. 44BBA—*see* para 162.9].

18. Special provisions in the case of certain turnkey power projects [Sec. 44BBB—*see* para 162.10].

19. Special provisions in the case of royalty income of foreign companies [Sec. 44D—*see* para 162.12].

20. Profits and gains from industrial undertakings engaged in infrastructure, etc. [Sec. 80-IA—*see* para 253].

21. Profits and gains from certain industrial undertakings other than infrastructure development undertakings [Sec. 80-IB—*see* para 254].

22. Profits from industrial undertakings situated in certain States [Sec. 80-IC—*see* para 255].

23. Profits and gains from the business of collecting and processing of bio-degradable waste [Sec. 80JJA—*see* para 256].

24. Employment of new workmen [Sec. 80JJAA—*see* para 257].

25. Special tax provision under sections 115A, 115AB, 115AC, 115AD, 115B, 115BB, 115BBA and 115D [*see* para 162].

526.3 ***Form of organisation*** - Among other considerations (like requirement of finance, resources, personal liability of owner, level of operation, quantum of profit, specified requirement of technical expertise), tax incentives play important role while selecting a suitable form of organisation for a new business. One can take a decision while comparing tax liability under different organisation forms.

526.3-1 *WHETHER SOLE PROPRIETORSHIP IS A BETTER ALTERNATIVE* - *See* para 327.1.

526.3-2 *FIRM* v. *COMPANY* - *See* para 327.2.

Tax planning with reference to financial management decisions

527. Many tax provisions affect financial management decisions. Some of these provisions are narrated below :

527.1 ***Capital structure*** - *See* para 164.4.

527.2 ***Dividend policy*** - *See* para 193 for meaning of dividend and tax treatment in the hands of shareholders, para 407 for deduction of tax at source under section 194 and para 337 for tax on distributed profits.

527.3 ***Inter-corporate dividend*** - Tax treatment of inter-corporate dividend is given in para 193.

527.4 ***Bonus shares*** - Tax consideration is given below —

527.4-1 *BONUS SHARES TO EQUITY SHAREHOLDERS* - The table given below highlights the tax consequences —

Situations	*Tax treatment in the hands of company issuing bonus shares*	*Tax treatment in the hands of shareholders*
■ At the time of issue of bonus shares	No tax liability	No tax liability
■ At the time of sale of bonus share by shareholder	No tax liability	*See* para 176.7
■ At the time of redemption of bonus share or at the time of liquidation of the company	Under section 2(*22*)(*a*) or 2(*22*)(*c*), it will be treated as dividend distribution to the extent of accumulated profits and, consequently, the payer company will pay dividend tax	Out of the amount received at the time of redemption or liquidation, amount treated as "dividend" under section 2(*22*)(*a*)/(*c*) will be exempt in the hands of shareholders, balance will be sale consideration to compute capital gain

527.4-2 *BONUS SHARES TO PREFERENCE SHAREHOLDERS* - Rarely bonus shares are issued to preference shareholders. Tax treatment is given below—

Situation	*Issued before June 1, 1997*		*Issued after May 31, 1997*	
	Company	*Shareholder*	*Company*	*Shareholders*
■ At the time of issue of bonus shares	No tax liability	It will be deemed as dividend under section 2(*22*)(*b*)	Under section 2(*22*)(*b*) it will be deemed as dividend and chargeable to dividend tax	No tax liability
■ At the time of sale by shareholder	No tax liability	*See* para 176.7	No tax liability	*See* para 176.7

Situation	Issued before June 1, 1997		Issued after May 31, 1997	
	Company	Shareholder	Company	Shareholders
■ At the time of redemption or liquidation (if the amount is equal to face value)	No tax liability	No tax liability	No tax liability	No tax liability

Tax planning with reference to specific managerial decisions

528. Tax provisions affecting various managerial decisions are given below :

528.1 ***Make or buy*** - Many costing or non-costing considerations guide the decision relating to "make or buy". Some of these considerations are - (*a*) utilisation of capacity, (*b*) inadequacy of funds, (*c*) latest technology, (*d*) variable cost of manufacturing *vis-a-vis* purchase price, (*e*) dependence upon supplier, (*f*) labour problem in the factory, etc. The following tax consideration one has to keep in mind while taking "make or buy" decision —

1. Establishing a new unit - If the decision to manufacture a part or component involves setting up a separate industrial unit, then tax incentives available under sections 10A, 10B, 32, 80-IA and 80-IB one has to keep in mind [*see* paras 39, 40, 109, 164.1, 253 and 254].

2. Export - If "make or buy" decision is taken for exporting goods, then tax incentive is available under section 10B in case the assessee is a newly established hundred per cent export oriented undertaking [for detailed discussion, *see* para 40].

3. Sale of plant and machinery - If buying is cheaper than manufacturing and the assessee decides to "buy" parts/components for a long period of time, he may like to sell the existing plant and machinery. Tax implications, as specified by section 50, one has to consider for taking the decision [*see* para 173.1-3].

528.1-P1 *X Ltd. manufactures electric pumping sets. The company has the option to either make or buy from the market component Y used in manufacture of the sets.*

The following details are available :

The component will be manufactured on new machine costing Rs. 1 lakh with a life of 10 years. Material required cost Rs. 2 per kg. and wages Re. 0.30 per hour. The salary of the foreman employed is Rs. 1,500 per month and other variable overheads include Rs. 20,000 for manufacturing 25,000 components per year. Material requirement is 25,000 kgs. and requires 50,000 labour hours.

The component is available in the market at Rs. 4.30 per piece.

Will it be profitable to make or to buy the component ? Does it make any difference if the component can be manufactured on an existing machine.

SOLUTION :

The cost estimate of manufacture will be :

	Rs.
Material @ Rs. 2 kg. (25,000 × Rs. 2)	50,000
Labour @ 0.30 hour (50,000 × Rs. 0.30)	15,000
Foreman's salary (Rs. 1,500 × 12)	18,000
Variable overhead	20,000
Total variable cost	1,03,000
Cost per unit (*i.e.*, Rs. 1,03,000 ÷ 25,000) (*a*)	4.12
Fixed cost	
Cost of new machine (net of taxes) [see table 4, para 164.2]	81,160
Net fixed cost per unit (*i.e.*, Rs. 81,160 ÷ 2,50,000 units to be manufactured in 10 years) (*b*)	0.325
Total [(*a*) + (*b*)]	4.45

Conclusion

	If new machine is required	If existing machine can be used
	Rs.	Rs.
Cost of manufacturing	4.45	4.12
Cost of buying	4.30	4.30
Which one is better	Buy	Make

528.1-P2 *XYZ Ltd. needs a component in an assembly operation. It is contemplating the proposal to either make or buy the aforesaid component.*

1. *If the company decides to make the product itself, then it would need to buy a machine for Rs. 8 lakh which would be used for 5 years. Manufacturing costs in each of the five years would be Rs. 12 lakh, Rs. 14 lakh, Rs. 16 lakh, Rs. 20 lakh and Rs. 25 lakh respectively. The relevant depreciation rate is 15 per cent. The machine will be sold for Rs. 1 lakh at the beginning of the sixth year.*

2. *If the company decides to buy the component from a supplier the component would cost Rs. 18 lakh, Rs. 20 lakh, Rs. 22 lakh, Rs. 28 lakh and Rs. 34 lakh respectively in each of the five year.*

The relevant discounting rate and tax rate are 14 per cent and 33.99 per cent respectively. Additional depreciation is not available. Should XYZ Ltd. make the component or buy from outside ?

SOLUTION : *Alternative 1* - Make the component

Year	Depreciation Rs.	WDV Rs.
1	1,20,000	6,80,000
2	1,02,000	5,78,000
3	86,700	4,91,300
4	73,695	4,17,605
5	62,641	3,54,964

Computation of short-term capital loss

	Rs.
Sales consideration	1,00,000
Less: Cost of acquisition	3,54,964
Short-term capital loss	(-) 2,54,964

Year	Manufacturing cost Rs.	Depreciation Rs.	Tax saving Rs.	Cash outflow from operations (COFO) Rs.
1	12,00,000	1,20,000	4,48,668	7,51,332
2	14,00,000	1,02,000	5,10,530	8,89,470
3	16,00,000	86,700	5,73,309	10,26,691
4	20,00,000	73,695	7,04,849	12,95,151
5	25,00,000	62,641	8,71,042	16,28,958

Discounted cash flow analysis of make proposal

	Year	PVFA	Cash outflow	PV Rs.
Investment	0	1	8,00,000	8,00,000
Cash outflow	1	0.877	7,51,332	6,58,918
Cash outflow	2	0.769	8,89,470	6,84,002
Cash outflow	3	0.675	10,26,691	6,93,016

	Year	PVF/A	Cash outflow	PV Rs.
Cash outflow	4	0.592	12,95,151	7,66,729
Cash outflow	5	0.519	16,28,958	8,45,429
Sale of machine	6	0.519	1,00,000	(-)51,900
				43,96,194

Alternative 2 - Buy the component

Year	Purchase cost Rs.	Tax saving Rs.	Cash outflow from operations (COFO) Rs.
1	18,00,000	6,11,820	11,88,180
2	20,00,000	6,79,800	13,20,200
3	22,00,000	7,47,780	14,52,220
4	28,00,000	9,51,720	18,48,280
5	34,00,000	11,55,660	22,44,340

Discounted cash flow analysis of buy proposal

	Year	PVF/A	Cash outflow Rs.	PV Rs.
Cash outflow	1	0.877	11,88,180	10,42,034
Cash outflow	2	0.769	13,20,200	10,15,234
Cash outflow	3	0.675	14,52,220	9,80,249
Cash outflow	4	0.592	18,48,280	10,94,182
Cash outflow	5	0.519	22,44,340	11,64,812
				52,96,510

Decision - The above analysis shows that there are considerable savings in making the component, amounting to Rs. 9,00,316 (*i.e.*, Rs. 52,96,510 – Rs. 43,96,194). Hence, it is beneficial to manufacture the component. Moreover, XYZ Ltd. will have a short-term capital loss of Rs. 2,54,964 after the end of the fifth year. Assuming that, it has an equal amount of short-term capital gain also this will result in tax savings of Rs. 86,663 at the current corporate tax rate (*i.e.*, Rs. 2,54,964 × 33.99%).

528.2 ***Own or lease*** - *See* para 164.2.

528.3 ***Purchase by instalment* v. *Hire*** - *See* para 164.3.

528.4 ***Capitalisation of interest on borrowed capital/travelling expenses*** - *See* para 164.2.

528.5 ***Repair, replace, renewal or renovation*** - The main tax consideration which one has to keep in mind is whether expenditure on repair, replacement or renewal is deductible as revenue expenditure under section 30, 31, or 37(1). If the expenditure is deductible as revenue expenditure under these sections, then cost of financing such expenditure is reduced to the extent of tax saved. For instance, if tax rate is 35 per cent and a "renewal" expenditure of Rs. 1,00,000 is allowed as deduction under section 30, 31 or 37(1), then effective out of pocket expenditure is Rs. 65,000 [*i.e.*, Rs. 1,00,000 *minus* 35 per cent of Rs. 1,00,000]. On the other hand, if such expenditure is not allowed as deduction under section 30, 31 or 37(1), then it may be capitalised and on the amount so capitalised depreciation is available if certain conditions are satisfied [*see* para 109.1].

528.5-P1 *XYZ Ltd. is considering the purchase of a new machine costing Rs. 60,000 with an expected life of 5 years with salvage value of Rs. 3,000, in replacement of an old machine purchased 3 years ago for Rs. 30,000 with expected life of 8 years. The present market value of this old machine is Rs. 35,000. Because of the purchase of new machinery, the annual profits before depreciation are expected to increase by Rs. 12,000. The relevant depreciation rate for the machine is 15 per cent on written down value basis and the tax rate is 33.99 per cent. Assume the after tax cost of capital (discounting rate) to be 14 per cent. Advise the company suitably.*

SOLUTION :

Assumptions :

1. It is assumed that the old machine is sold and the new machine is purchased at the beginning of fourth year of the purchase of old machine.

2. There is no other asset in the block.

Working note

Computation of the written down value of the old machine (after providing three years depreciation)

Year	Depreciation Rs.	WDV Rs.
1	4,500	25,500
2	3,825	21,675
3	3,251	18,424

	Rs.
WDV of the old machine (in the beginning of the fourth year)	18,424
Add : Purchases	60,000
Total	78,424
Less : Sales	35,000
WDV at the beginning of fourth year for old machine (or first year for new machine)	43,424

Future years	Change in depreciation Rs.	Change in WDV Rs.
1	25,000 × 0.15 = 3,750 (60,000 — 35,000)	21,250 (25,000—3,750)
2	21,250 × 0.15 = 3,188	18,062 (21,250—3,188)
3	18,062 × 0.15 = 2,709	15,353 (18,062 — 2,709)
4	15,353 × 0.15 = 2,303	13,050 (15,353 — 2,303)
5	10,050 Short-term capital loss (13,050 — 3,000)	

Future years	Change in profit Rs.	Change in depreciation Rs.	Change in tax Rs.	Change in cash flow Rs.
1	12,000	3,750	2,804	9,196
2	12,000	3,188	2,995	9,005
3	12,000	2,709	3,158	8,842
4	12,000	2,303	3,296	8,704
5	12,000	10,050	662	11,338

Discounted cash flow analysis of the project

	Year	PVF/A	Cash flow Rs.	Present value Rs.
Net investment	0	1	– 25,000	– 25,000
Cash in flow from operations	1	0.877	+ 9,196	+ 8,065
Cash in flow from operations	2	0.769	+ 9,005	+ 6,924
Cash in flow from operations	3	0.675	+ 8,842	+ 5,968
Cash in flow from operations	4	0.592	+ 8,704	+ 5,152
Cash in flow from operations	5	0.519	+ 11,338	+ 5,884
Sale of scrap	6	0.519	+ 3,000	+ 1,557
Net present value				+ 8,523

Decision - Since the net present value on the basis of the abovestated analysis is positive, the old machine should be replaced with the new machine.

528.6 ***Shut down or continue*** - *See* para 229.1-3.

Tax planning in respect of employees' remuneration

529. Two factors require consideration in the case of remuneration planning. First, one has to ensure that while calculating business income of the employer, remuneration paid to employees are fully deductible. If such expenditure is not allowed as deduction (or disallowed under any of the provisions), then tax bill of the employer increases. On other hand, one has to see that remuneration received by the employees is taxable in their hands at concessional rates, to minimise their tax bill and to maximise their take home pay.

529.1 ***Deduction of remuneration in the hand of employer*** - Tax provisions affecting deduction of remuneration in the hand of employers are given below:—

1. Remuneration to employees engaged in carrying on scientific research [Sec. 35(1)—*see* para 114.1].

2. Insurance premium on health of employees [Sec. 36(1)(*ib*)—*see* para 125].

3. Bonus and commission to employees [Sec. 36(1)(*ii*) read with section 43B—*see* paras 126 and 155].

4. Employers' contribution towards provident fund/gratuity fund [Sec. 36(1)(*iv*)/(*v*) read with sections 40A(9) and 43B—*see* paras 128, 129, 151, 153 and 155].

5. Employees' contribution to staff welfare schemes [Sec. 36(1)(*va*)—*see* para 130].

6. Family planning expenditure [Sec. 36(1)(*ix*)—*see* para 135].

7. Payment of salary/allowances and perquisites [Sec. 37(1)—*see* para 141].

8. Salary payable outside India [Sec. 40(*a*)(*iii*)—*see* para 143.6].

9. Provident fund payment without tax deduction [Sec. 40(*a*)(*iv*)—*see* para 143.7].

10. Payment of salary to relatives [Sec. 40A(2)—*see* para 147].

11. Payment of salary exceeding Rs. 20,000 in cash or by bearer cheque [Sec. 40A(3)—*see* para 148].

Besides the above provisions, the employer has to ensure that proper tax is deducted at source under section 192 [*see* paras 405 and 426].

529.2 ***Tax incidence in the hands of employees*** - To find out tax incidence in respect of salary received by an employee, one has to study the provisions of sections 5, 6, 9, 10, 15, 16, 17, 89 and 80CCC to 80U [*see* paras 46 to 63, 237 to 267].

529.3 ***Tax planning*** - While framing salary structure of employees, one has to keep in view tax planning hints given in para 62. Tax bill of employees can be reduced substantially if salary is divided into different allowances (which are not taxable or which are partially exempt from tax) and perquisites (which are taxable at concessional rates). The optimum combination of allowances and perquisites depends upon individual requirement of each employee taking into consideration present take-home pay and future benefits of different items in salary structure. The following case study is undertaken to highlight the aforesaid propositions—

Case study - X has been offered an employment on monthly salary of Rs. 40,000. If Rs. 40,000 is received by X as salary, his tax liability will be as under —

Option 1

	Rs.
Salary (Rs. 40,000 × 12)	4,80,000
Less : Standard deduction	*Nil*
Net income	4,80,000
Tax on net income	52,530
Take-home pay (*i.e.*, Rs. 4,80,000 – Rs. 52,530)	4,27,470

Alternately, X can take the same salary in different forms of allowances/perquisites. While framing salary structure one is to ensure that expenditure incurred by the employer should be allowed as deduction and in the hands of the employee, the allowances/perquisites are not taxable or taxable at lower rate.

In the aforesaid case, X can take salary of Rs. 40,000 per month in the form of the following allowances/ perquisites —

Option 2

	Expenditure incurred by the employer Rs.	Amount taxable in the hands of the employees Rs.
Basic salary	1,80,000	1,80,000
Employer's contribution towards recognised provident fund	21,600	—
Transport allowance for commuting between office and residence	9,600	—
Education allowance for two children	2,400	—
Academic research allowance [*on the assumption that the amount is used for conducting research]	24,127	*Nil**
Uniform allowance [*on the assumption that the amount is used for purchase and maintenance of uniform for official purposes]	30,000	*Nil**
Rent-free house in Bombay (rent paid by employer)	1,08,000	27,000
Free car with driver for official and private use but not for commuting between office and residence (cubic capacity of engine 1.3 litres)	50,400	*Nil*
Free telephone and mobile phone	36,000	*Nil*
Leave travel concession (twice in a block of 4 years) (one year's expenses are given on proportionate basis) [*on the assumption the amount is actually used for travelling and it does not exceed economy class air fare]	12,000	*Nil**
Fringe benefit tax to be borne by employer [*i.e.*, 33.99% of 20% of Rs. 50,400 + Rs. 36,000]	5,873	*Nil*
Total expenditure/gross salary	4,80,000	2,07,000
Less : Deduction under section 80C (being employee's contribution towards PF)	-	21,600
Net income	-	1,85,400
Tax on net income		3,646
Take-home pay (*i.e.*, Rs. 1,80,000 + Rs. 9,600 + Rs. 2,400 + Rs. 24,127 + Rs. 30,000 + Rs. 12,000 — Rs. 3,646 — Rs. 21,600 being X's contribution towards provident fund)		2,32,881

Comparison of options 1 and 2

	Option 1 Rs.	Option 2 Rs.
Take-home pay	4,27,470	2,32,881
Less : Payment by X for —		
- House accommodation	1,08,000	—
- Car and driver	50,400	—
- Telephone and mobile phone	36,000	—
- Future saving (Rs. 21,600 + Rs. 21,600)	43,200	—
Balance	1,89,870	2,32,881

The difference of Rs. 43,011 between the two options is because of lower tax bill under option 2 (*i.e.*, Option 1: Rs. 52,530, Option 2 : Rs. 3,646 + Rs. 5,873)

Tax planning in respect of non-residents

530. Provisions regulating tax liability of non-residents are available under different sections of the Act as follows —

1. Meaning of non-resident [Sec. 6—*see* paras 24.3, 25, 26 and 27].

2. Incidence of tax in the case of a non-resident [Sec. 5(2)—*see* para 29.3].

3. Income deemed to accrue or arise in India [Sec. 9—*see* para 32].

4. Interest to non-residents [Sec. 10(*4*), (*4B*)—*see* para 38.5].

5. Salary to non-residents [Sec. 10(*6*)—*see* paras 54 and 55].

6. Tax paid on behalf of non-residents [Sec. 10(*6A*), (*6B*)—*see* paras 38.12 and 38.13].

7. Technical fees received by a notified foreign company [Sec. 10(*6C*)—*see* para 38.14].

8. Fees received by non-resident consultants and their employees [Sec. 10(*8A*), (*8B*)—*see* para 38.17].

9. Interest exempt under section 10(*15*)—[*see* para 196.5].

10. Aircraft lease rent [Sec. 10(*15A*)—*see* para 38.31].

11. Shipping profits of non-residents [Sec. 44B—*see* para 162.7].

12. Income of foreign airlines [Sec. 44BBA—*see* para 162.9].

13. Profit of the business of civil construction [Sec. 44BBB—*see* para 162.10].

14. Head office expenses in the case of non-residents [Sec. 44C—*see* para 162.11].

15. Royalty and technical fees in the case of non-residents [Sec. 44D—*see* para 162.12]

16. Computation of income and tax under sections 115A, 115AB, 115AC, 115AD, 115BBBA and 115D—[*see* para 162.13].

17. Capital gains computation in the case of non-residents [Sec. 48—*see* para 176.5].

18. Special provisions relating to non-resident Indians [Secs. 115C to 115-I—*see* para 287.1].

530.1 ***Relief for double taxation [Secs. 90, 90A and 91]*** - Foreign income of a person generally becomes liable to tax in two countries - the country in which income is earned and the country in which the person is resident. Double taxation of such income is avoided by means of double taxation avoidance agreements (ADT) entered into by the Government of India with the Governments of other countries under section 90. Where the income accrues or arises in a country with which no agreement exists, unilateral tax relief is provided on the doubly taxed income under the provisions of section 91.

530.1-1 *AVOIDANCE OF DOUBLE TAXATION AGREEMENTS [SEC. 90]* - The Government of India has entered into comprehensive agreements for avoidance of double taxation with 57 countries. Besides, the Government of India has entered into agreements which cover limited areas of activity like aircraft and shipping business.

530.1-1a MODES OF GRANTING RELIEF UNDER ADT AGREEMENTS - Generally, there are two modes of granting relief under ADT agreements - (*a*) exemption method, and (*b*) tax credit method. Under exemption method a particular income is taxed in one of the two countries. Under tax credit method, an income is taxable in both the countries in accordance with their respective tax laws read with the ADT agreement*. However, the country of residence of the taxpayer allows him credit for the tax charged thereon in the country of source against the tax charged on such income in the country of residence.

In India's ADT agreements, double taxation relief is provided by a combination of the two modes.

*Where an avoidance of double taxation agreement provides that any income of a resident of India "may be taxed" in the other country, such income shall be included in his total income chargeable to tax in India in accordance with the provisions of the Income-tax Act and relief shall be granted in accordance with the method for elimination or avoidance of double taxation provided in such agreement—**Notification Nos. 90/2008, 91/2008,** dated August 28, 2008.

The effect of an ADT agreement is as follows —

a. if no tax liability is imposed under the Act, the question of resorting to the agreement would not arise, no provision of the agreement can possibly fasten a tax liability where the liability is not imposed by the Act ;

b. if a tax liability is imposed by the Act, the agreement may be resorted to for negativing or reducing it ;

c. in case of difference between the provisions of the Act and of the agreement, the provisions of the agreement prevail over the provisions of the Act and can be enforced by the appellate authorities and the court [to the same effect is the Circular No. 333, dated April 2, 1982 issued by the Central Board of Direct Taxes].

▪ Provisions of India's ADT agreements regarding taxation of dividend, interest, royalty and technical fees are summarised in para 0.10 (Annex 1).

▪ Provisions of section 90 are to be invoked for granting relief to the assessee if the income of the non-resident assessee is chargeable to tax under sections 4, 5 and 9; if the income of non-resident is not chargeable to tax under the Act, the question of invoking the provisions of section 90 would not arise at all—***Sheraton International Inc.*** v. ***CIT*** [2003] ITD 110 (Delhi).

▪ Provisions of DTAAs override the provisions of the Act, to the extent these agreements are more favourable to the assessee—*CIT* v. *ITC Ltd.* [2002] 82 ITD 239 (Kol.).

530.1-2 *UNILATERAL RELIEF [SEC. 91]* - Section 91 provides for the grant of unilateral relief in the case of resident taxpayers on income which has suffered tax in India as well as in the country with which there is no ADT agreement.

The following requirements have to be satisfied in order that an assessee is entitled to claim deduction on the doubly taxed income :

a. the assessee must have been resident in India in the relevant previous year ;

b. income must have accrued or arisen to him during that previous year outside India ;

c. in respect of that income which accrued or arose outside India, he must have paid by deduction or otherwise tax under the law in force in the country in question.

The relief is worked out as under :

1. First, ascertain the amount of doubly taxed income. It consists of such income as has accrued or arisen to the taxpayer in a foreign country and has been subjected to income-tax in that country as well as India. It, however, does not include income which is deemed to have accrued or arisen to the taxpayer in India, even though it has been charged to income-tax in a foreign country.

2. On the amount of the doubly taxed income so ascertained, income-tax is calculated at the Indian rate of tax and the rate of tax of the foreign country. The foreign tax rate has to be calculated separately for each country—***CIT*** v. ***Bombay Burmah Trading Corpn. Ltd.*** [2003] 126 Taxman 403 (Bom.).

3. Relief is granted by allowing to the taxpayer a deduction from the tax liability of an amount equal to the tax calculated at the average Indian rate of tax or the amount of tax calculated at the rate of tax of the other country on the doubly taxed income, whichever is lower. For example, if out of income of Rs. 48,000 deduction of Rs. 36,000 is allowed under section 80RRA in computing the total income, the assessee will be entitled to the double taxation relief under section 91 only in respect of Rs. 12,000 which has been subjected to income-tax in India.

▪ *What is Indian rate* - The Indian rate of tax means the rate determined by dividing the amount of Indian income-tax after deduction of any relief due under the provisions of the Act, but before deduction of any relief due under sections 90 and 91, by the total income.

■ *What is foreign rate* - The rate of tax of the foreign country means income-tax and supertax actually paid in that country in accordance with the corresponding laws in force thereafter deduction of all relief due, divided by the whole amount of the income as assessed in that country.

530.1-3 ***DOUBLE TAXATION RELIEF IN CASE OF SPECIFIED ASSOCIATIONS [SEC. 90A]*** - With effect from the assessment year 2006-07, section 90A has been inserted. It provides for the following—

■ There is a specified association in India.

■ It enters into an agreement with any specified association in a specified territory outside India.

■ The Central Government may, by notification in the Official Gazette, make the necessary provisions for adopting and implementing such agreement—

a. for grant of double taxation relief, for avoidance of double taxation ;

b. for exchange of information for the prevention of evasion or avoidance of income tax ;

c. for recovery of income tax.

■ In relation to any assessee to whom the said agreement applies, the provisions of the Income-tax Act shall apply to the extent they are more beneficial to that assessee.

530.1-P1 *Find out the tax liability for the assessment year 2009-10 in the following cases —*

1. X (28 years) is resident and ordinarily resident in India. His income is Rs. 8,96,000 from a business in India and Rs. 1,92,000 from a business in a foreign country with whom India has an ADT agreement. According to the ADT agreement, income is taxable in the country in which it is earned and not in the other country. However, in the other country such income can be included for computation of tax rate. According to the tax laws of the foreign country, business income of Rs. 1,92,000 is taxable @ 23 per cent. During the previous year, X has deposited Rs. 42,000 in his public provident fund account (out of which Rs. 10,000 is deposited out of foreign income). He has also received an interest of Rs. 32,000 on Government securities.

2. X Ltd. is an Indian company. For the previous year 2008-09, the following incomes are noted from the books of account of the taxpayer —

	Rs.
Income from a business in India	*3,80,000*
Income from a business in a foreign country with whom India has ADT agreement	*2,16,000*

According to the ADT agreement, Rs. 2,16,000 is taxable in India. However, it can also be taxed in the foreign country @ 17.5 per cent which can be set off against Indian tax liability.

3. Y (24 years) and Z (26 years) are resident in India. The following points are noted for the previous year 2008-09 from the books of account —

	Y	Z
	Rs.	Rs.
Income from a business in India	*80,000*	*(–)1,30,000*
Income from business in Argentina (India does not have ADT agreement with Argentina)	*1,30,000*	*4,00,000*
Income from other sources in India (bank interest)	*60,000*	*80,000*
PPF contribution	*16,000*	*1,500*
Tax levied in Argentina	*39,000*	*20,000*

SOLUTION :

1. Computation of income and tax of X

	Rs.
Business income in India	8,96,000
Interest on Government securities	32,000
Gross total income	9,28,000

	Rs.
Less : Deduction under section 80C	42,000
Net income	8,86,000
Foreign income to be included for rate purposes	1,92,000
Total	10,78,000
Tax on Rs. 10,78,000 [see Annex 1]	2,28,400
Add : Surcharge	22,840
Tax and surcharge	2,51,240
Add: Education cess (2% of tax and surcharge)	5,025
Add : Secondary and higher education cess [1% of tax and surcharge]	2,512
Tax payable	2,58,777
Average rate of tax [Rs. 2,58,777/Rs. 10,78,000 × 100]	24.01%
Indian tax liability (*i.e.*, tax on Rs. 8,86,000 @ 24.01%)	2,12,690

2. Computation of income and tax of X Ltd.

	Indian tax Rs.	Foreign tax Rs.
Business income in India	3,80,000	—
Foreign business income	2,16,000	2,16,000
Net income	5,96,000	2,16,000
Tax on net income [@ 30.9% in India and 17.5% in foreign country]	1,84,164	37,800
Less : Tax paid in foreign country	37,800	
Indian tax liability	1,46,360	—

3. Computation of income and tax of Y and Z

	Y Rs.	Z Rs.
Business income	2,10,000	2,70,000
Bank interest	60,000	80,000
Gross total income	2,70,000	3,50,000
Less : Deduction under section 80C	16,000	1,500
Net income	2,54,000	3,48,500
Tax	10,400	24,700
Add : Surcharge (not applicable in case net income exceeds Rs. 10 lakh for the assessment year 2009-10)	*Nil*	*Nil*
Tax and surcharge	10,400	24,700
Add: Education cess (2% of tax and surcharge)	208	494
Add : Secondary and higher education cess [1% of tax and surcharge]	104	247
Indian tax liability	10,712	25,441
Indian average rate of tax (*a*)	4.22%	7.30%
Argentine average rate of tax [Rs. 39,000/Rs. 1,30,000; Rs. 20,000/Rs. 4,00,000] (*b*)	30%	5%
Rate at which rebate is admissible under section 91 [(*a*) or (*b*), whichever is lower]	4.22%	5%
Doubly taxed income	1,30,000	3,48,500
Amount of rebate [4.22% of Rs. 1,30,000 and 5% of Rs. 3,48,500]	5,483	17,425
Tax payable in India (rounded off)	5,230	8,020

530.1-P2 *X (68 years) is a musician deriving income from concerts performed outside India of Rs. 9,50,000. Tax of Rs. 1,90,000 was deducted at source in the country where the concerts were given and remaining Rs. 7,60,000 is remitted to India. India does not have any agreement with that country for avoidance of double taxation. Assuming that the Indian income of X is Rs. 2,00,000, what is the relief due to him under section 91 for assessment year 2009-10, assuming that X has deposited Rs. 22,000 in the public provident fund account during the previous year 2008-09.*

SOLUTION :

	Rs.
Indian income	2,00,000
Foreign income	9,50,000
Gross total income	11,50,000
Less : Deduction under section 80C	22,000
Net income	11,28,000
Tax on net income	2,35,900
Add : Surcharge	23,590
Tax and surcharge	2,59,490
Add : Education cess (2% of tax and surcharge)	5,190
Add : Secondary and higher education cess [1% of tax and surcharge]	2,595
Tax	2,67,275
Rate of tax in India [*i.e.*, Rs. 2,67,275 ÷ Rs. 11,28,000]	23.69%
Rate of tax in foreign country [*i.e.*, Rs. 1,90,000 ÷ Rs. 9,50,000]	20%
Doubly taxed income	9,50,000
Rebate under section 91 on Rs. 9,50,000 @ 20%	1,90,000
Tax payable in India	77,270

530.2 ***Advance rulings for non-residents*** - *See* paras 486 to 491.

Tax planning in respect of amalgamation or demerger of companies or business restructuring

531. *See* paras 515 to 521.

Miscellaneous

TONNAGE TAX

Introduction of Tonnage Tax [Secs. 115V to 115VZC]

532. To make the Indian shipping industry more competitive, a tonnage tax scheme for taxation of shipping profits has been introduced. Many maritime nations have introduced tonnage based taxation. Some of the basic features of the tonnage tax scheme are as follows:—

- It is a scheme of presumptive taxation whereby the notional income arising from the operation of a ship is determined based on the tonnage of the ship.
- The notional income is taxed at the normal corporate rate applicable for the year.
- Tax is payable even if there is a loss in an year.
- A company may opt for the scheme [Form No. 65] and once such option is exercised, there is a lock-in-period of 10 years. If a company opts out, it is debarred from re-entry for ten years.
- Since this is a preferential regime of taxation, certain conditions like creation of reserves, training, etc., are required to be met.
- A company may be expelled in certain circumstances.

532.1 ***Salient features*** - The salient features of the scheme which is applicable from the assessment year 2005-06 are as follows:

- A company owning at least one qualifying ship may join. A qualifying ship is one with a minimum tonnage of 15 tons and having a valid certificate. The company has to opt for the scheme within 3 months, *i.e.*, any time between October 1, 2004 to December 31, 2004 by making an application in the prescribed form to the concerned Joint Commissioner who may pass an appropriate order. A new company can make application within three months of the date of its incorporation or the date on which it became a qualifying company, as the case may be.
- Certain types of ships like fishing vessels, pleasure crafts, harbour and river ferries, etc., are excluded in terms of section 115VD which gives details of as to what ships will qualify for the scheme.
- The business of operating qualifying ships is to be considered a separate business and separate accounts are to be maintained. Section 115VG gives the manner of computation of the daily tonnage income as follows—

Qualifying ship having net tonnage	*Amount of daily tonnage income*
Up to 1,000	Rs. 46 for each 100 tons
Exceeding 1,000 but not more than 10,000	Rs. 460 *plus* Rs. 35 for each 100 tons exceeding 1,000 tons
Exceeding 10,000 but not more than 25,000	Rs. 3,610 *plus* Rs. 28 for each 100 tons exceeding 10,000 tons
Exceeding 25,000	Rs. 7,810 *plus* Rs. 19 for each 100 tons exceeding 25,000 tons.

The daily tonnage income shall be multiplied by the number of days the ship operated. The resulting amount would be the annual tonnage income from the ship. A company owning at least one ship may charter in ships subject to certain limits for the purpose of operation. Relevant shipping income, which replaces the actual income from the operations, is defined in section 115VI. Section 115VJ gives the treatment of common costs.

Provisions illustrated - Suppose a tonnage tax company operates only one qualifying ship throughout the previous year 2008-09. The ship has a net tonnage of 25,000 tons and the corporation tax rate for that year is 30.9 per cent. Tonnage tax liability of such company would be calculated as follow:

Daily profit:	Rs.
For the first 1,000 tons	460
For 1,001 to 10,000 tons	3,150
For remaining 15,000 tons	4,200
Total	7,810
Notional annual profit:	
Rs. 7810 × 366 days	Rs. 28,58,460
Tonnage tax: Rs. 28,50,650 × 30.9%	Rs. 8,83,264

■ A company opting for the scheme is not allowed any set-off of loss nor is any depreciation allowed. However, both loss and depreciation are deemed to have been allowed and notional adjustments are made against the relevant shipping income. Although depreciation is not allowed, it is necessary to bifurcate the qualifying ships and non-qualifying ships at the time a company joins the scheme. Section 115VK lays down the method for allocating the written down value amongst qualifying and non-qualifying ships. Any income from transfer of qualifying assets is treated in the same manner as for any other business asset in terms of section 115VN.

Provisions illustrated - The WDV of the existing block under section 32 is Rs. 70 crore. This comprises three qualifying assets (Q) and two non-qualifying assets (NQ). The book WDV of each of the qualifying and the non-qualifying assets is identified as under as the first step :

Rs. in crore

	Assets	Book WDV
Q1	30	
Q2	20	
Q3	30	80
NQ1	15	
NQ2	5	20

Book WDV of all the existing qualifying assets is Rs. 80 crores and that for the non-qualifying is Rs. 20 crores. Thus, the ratio of book WDV of qualified assets to that of non-qualifying assets is 4:1. In the final step, the existing WDV of the common block, which is Rs. 70 crore, is to be allocated in this ratio of qualifying block and non-qualifying blocks. Accordingly, WDV of qualifying block would be Rs. 56 crore and that of non-qualifying block would be Rs. 14 crore - **Circular No. 05/2005,** dated July 15, 2005.

■ The profits from the business of operating qualifying ships will not be taken into consideration for the purpose of MAT as per section 115VO.

■ Section 115VP relates to method and time of opting for tonnage tax scheme. A qualifying company may opt for the tonnage tax scheme by making an application to the Joint Commissioner having jurisdiction over the company in Form No. 65 and manner prescribed in rule 11P. A Certificate of Registration under Merchant Shipping Act, 1958 and International Tonnage Certificate should accompany application in Form No. 65. The initial period in which a company will be able to opt for the scheme will be for a period of three months starting from October 1, 2004 and ending on December 31, 2004. After the end of the initial period, only those companies which are incorporated after the initial period or which become qualifying companies after the initial period for the first time (in case of existing companies) shall be able to opt for the scheme. In such cases, however, the application for exercising the option will have to be made within three months* of the date of the

*If an assessee had filed the application under section 115VP in time but Tonnage Certificate was submitted belatedly at the time of assessment (and the delay in submission of the valid Tonnage Certificate was under the circumstances beyond its control), the benefit of tonnage scheme as per the provisions of section 115VP cannot be denied—***CIT** v. ***EPSOM Shipping (I) (P.) Ltd.*** [2008] 24 SOT 192 (Mum.).

incorporation or, as the case may be, the date on which the company became a qualifying company—**Circular No. 05/2005**, dated July 15, 2005.

■ Section 115VQ lays down that once a company opts for the scheme, the option remains in force for 10 years except in certain circumstances. Section 115VS provides for the circumstances in which the tonnage tax company is prohibited from opting for the scheme. Such prohibition is for a period of 10 years. Sections 115VT, 115VU, 115VS and 115VW lay down the conditions for the applicability of the scheme. In terms of section 115VT, a tonnage tax company has to create a reserve of at least 20 per cent of its book profits to be utilized for the purpose of acquisition of new ships. As per section 115VU a tonnage tax company has to comply with a minimum training requirement in accordance with the guidelines to be issued by the DG (Shipping). The company will be expelled if the training requirements are not met for 5 consecutive years. Section 115VV lays down that every company which has opted for tonnage tax scheme, not more than 49 per cent of the net tonnage of the qualifying ships operated by it during any previous year shall be chartered in. In terms of section 115VW, maintenance of separate books of account and the audit of the same is compulsory for a company opting for the scheme. Section 115VX lays down the details regarding valid certificate which indicates the net tonnage of ships. Sections 115VY and 115VZ provide for the contingencies of amalgamation and demerger. Section 115VZB enjoins upon a company not to abuse the preferential tax regime and section 115VZC provides for expulsion of a company in case of abuse.

SECURITIES TRANSACTION TAX

Securities transaction tax

533. Securities transaction tax has been levied [*see* para 533.3] on the value of taxable securities transactions. The provisions relating to the transaction tax are contained in Chapter VII of the Finance (No. 2) Act, 2004, and shall take effect from October 1, 2004.

533.1 ***Charge of security transaction tax*** - Securities transaction tax is applicable in respect of the following transactions—

1. Purchase or sale of an equity share in a company or a derivative or a unit of an equity oriented fund, entered into in a recognized stock exchange.

2. Sale of unit of an equity oriented fund to the mutual fund.

■ *Equity oriented fund* - If the following two conditions are satisfied, the fund is known as "equity oriented fund"—

a. more than 65 per cent (up to May 31, 2006 : 50 per cent) of the total proceeds of the fund is invested in equity shares in domestic companies, and

b. the fund has been set up under a scheme of mutual fund.

For the above purpose, the percentage of equity share holding of the fund shall be computed with reference to the annual average of the monthly averages of the opening and closing figures.

533.2 ***Value of taxable securities*** - The value of a taxable securities transaction shall be computed as follows:—

a. in the case of a taxable securities transaction relating to a derivative (being "option in securities"), it shall be the aggregate of the strike price and the option premium of such "option in securities";

b. in the case of any other taxable securities transaction relating to a derivative (being future), it shall be the price at which such "futures" is traded; and

c. in the case of any other taxable securities transaction, it shall be the price at which such securities are purchased or sold.

The Board may specify (having regard to the manner in which taxable securities transactions are settled in a recognised stock exchange), the method of determining the price of securities for the aforesaid purpose.

533.3 ***Rate of tax*** - *See* Annexure 1, para 0.10-1.

533.4 ***Collection and recovery of tax*** - Every recognized stock exchange shall collect the securities transaction tax from every person being a purchaser and seller of taxable securities in that stock exchange at the rates stated above. However, in the case of sale of units to the mutual fund, it shall be collected by the prescribed person in the mutual fund. The amount of securities transaction tax collected by the recognised stock exchange/mutual fund has to be paid to the credit of the Government by 7th day of the month following the month in which the securities transaction tax is collected.

533.5 ***Return*** - A recognised stock exchange/prescribed person in every mutual fund shall be responsible for submission of a return in the prescribed form (Form No. 1 for stock exchange, Form No. 2 for mutual fund) of all taxable securities transactions entered into during a financial year on that stock exchange or, as the case may be, in respect of all taxable securities transactions, being sale of units to such mutual fund during such financial year. Such return should be submitted on or before June 30 after the end of the financial year. A revised return can be submitted before the assessment is made, in case of discovery of any omission or wrong statement in the return earlier furnished.

533.6 ***Issue of notice*** - The Assessing Officer may issue notice requiring any assessee who is responsible for collection of securities transaction tax, and has not furnished the return, to furnish such return within such time as may be specified in the notice.

533.7 ***Assessment***- Section 92 contains provisions relating to assessment of the value of taxable securities transactions and securities transaction tax payable or refundable on the basis of such assessment. It also provides that no assessment shall be made after the expiry of 2 years from the end of the relevant financial year.

533.8 ***Rectification*** - Mistakes apparent from record of any order passed by the Assessing Officer can be rectified within 1 year from the end of the financial year in which the order sought to be amended was passed. The Assessing Officer may rectify mistakes either *suo motu* or at the instance of the assessee. Further, any amendment which has the effect of enhancing an assessment or reducing a refund or otherwise increasing the liability of the assessee shall be made only after giving the assessee a reasonable opportunity of being heard.

533.9 ***Interest*** - A simple interest at the rate of 1 per cent, for every month (or part of a month) is applicable where the securities transaction tax collected is not credited to the account of the Central Government within the period specified above.

533.10 ***Penalty*** - The following penalties may be imposed on a recognized stock exchange/mutual fund —

If the recognized stock exchange/mutual fund fails to collect whole or any part of securities transaction tax	In addition of paying tax and interest, a penalty which is equal to 100 per cent of the amount of tax which is not collected may be imposed
If after collecting such tax, it is not paid to the credit of the Government within the specified time	In addition of paying tax and interest, a sum of Rs. 1,000 for each day during which the default continues may be imposed
If the recognized stock exchange/mutual fund fails to furnish return within the time given under section 91(1) or in response to notice	Rs. 100 per day for which the default continues
If any person has failed to comply with a notice under section 92(1)	In addition of paying tax and interest, a sum of Rs. 10,000 for each day during which the default continues may be imposed

Notes:

1. If the assessee proves that there was reasonable cause for the above failure, penalty cannot be imposed.

2. No order of imposing penalty can be made unless the assessee has been given a reasonable opportunity of being heard.

533.11 ***Application of certain provisions of the Income-tax Act*** - Sections 120, 131, 133A, 156, 178, 220 to 227, 229, 232, 260A, 261, 262, 265 to 269, 278B, 282 and 288 to 293 of the Income-tax Act which, *inter alia*, relate to issue of notice of demand, recovery and collection of tax, appeals to High Courts and Supreme Court, appearance of authorised representatives, etc., will, so far as may be, apply in relation to securities transaction tax.

533.12 ***Appeals*** - Section 100 provides for an appeal to the Commissioner of Income-tax (Appeals) when the assessee denies its liability to be assessed or against any order passed by an Assessing Officer. This section contains provisions relating to time-limit for filing appeal, etc., and provides that provisions of sections 249 to 251 of the Income-tax Act will, as far as may be, apply in such cases. Likewise, the provisions of sections 252 to 255 of the Income-tax Act shall apply for appeal to the Appellate Tribunal against an order passed by a Commissioner of Income-tax (Appeals).

533.13 ***Prosecution*** - Section 102 provides for punishment, by way of imprisonment up to a period of 3 years and with fine, for submitting any statement in any verification, account or statement which is false. It also provides that an offence punishable under these provisions shall be deemed to be non-cognisable within the meaning of the Code of Criminal Procedure, 1973. However, no prosecution shall be initiated except with the prior sanction of the Chief Commissioner of Income-tax.

TAX CLEARANCE CERTIFICATE

Tax clearance certificate

534. The scheme of section 230 has been modified with effect from June 1, 2003.

534.1 ***When a person is not domiciled in India [Sec. 230(1)]*** - The provisions of section 230(1) are given below—

534.1-1 CONDITIONS - Section 230(1) is applicable if the following conditions are satisfied—

1. The concerned person is a not domiciled in India.

2. He has come to India in connection with business, profession or employment.

3. He has income which is generated from any source in India.

534.1-2 NO OBJECTION CERTIFICATE - No objection certificate shall be issued as follows—

▪ *Undertaking from employer/payer of income* - If the aforesaid conditions are satisfied, the concerned person shall not leave India by land, sea or air unless he furnishes an undertaking as follows—

a. the undertaking should be in Form No. 30A from his employer or through whom such person is in receipt of the income ; and

b. such undertaking should be to the effect that tax payable by such person shall be paid by the employer or the person through whom any income is received.

▪ *No objection certificate* - If such person submits the undertaking to the prescribed authority (*i.e.*, CCIT or DG who has jurisdiction over the person not domiciled in India or other authority/ authorities by CCIT/DG) satisfying the above conditions, the prescribed authority shall on receipt of the undertaking, immediately give to such person a no objection certificate in Form No. 30B, for leaving India. A copy of Form No. 30A and certificate in Form No. 30B should be forwarded to CCIT or DG having jurisdiction over person mentioned in (*a*) *supra*.

534.1-3 EXCEPTIONS - The aforesaid requirement is not applicable in the following two cases—

▪ *Exception one* - If a person who is not domiciled in India but visits India as a foreign tourist or for any other purpose not connected with business, profession or employment.

▪ *Exception two* - If the case is covered by such exceptions as the Central Government may, by notification in the Official Gazette, specify in this behalf.

534.2 ***When a person is domiciled in India [Sec. 230(1A)]*** - If a person is domiciled in India, then he would be covered by the requirement of section 230 in one or both of the following two cases—

▪ *Case one - A self-declaration* - A self-declaration is necessary if the person who wants to leave the country is domiciled in India. The self-declaration should satisfy the following conditions—

a. it should be in Form No. 30C;

b. it should be given to the income-tax authority or a prescribed authority (*i.e.*, CCIT);

c. it should contain the permanent account number allotted under section 139A (in case no such permanent account number has been allotted to him, or his total income is not chargeable to income-tax or he is not required to obtain a permanent account number under the Act, such person shall furnish a certificate in the prescribed form, *i.e.*, Annexure to Form No. 30C);

d. it should disclose the purpose of visit outside India; and

e. it should also disclose the estimated period of his stay outside India.

Every domiciled person should submit the aforesaid self-declaration at the time of departure (a few exception may be notified by the Central Government). Such person can leave the country without obtaining a certificate from income-tax authorities, unless he comes in *case two* (*infra*).

▪ *Case two - Obtaining a certificate from income-tax authority* - A certificate should be obtained from the concerned income-tax authority if the following conditions are satisfied—

1. The person is domiciled in India at the time of departure (application should in Form No. 31).

2. The concerned income-tax authority (*i.e.*, Assessing Officer) is of the opinion that in respect of such person certain circumstances exit[1] which render it necessary for such person to obtain a certificate under section 230(1A).

3. Such income-tax authority records the reasons for the circumstances mentioned above.

4. Prior approval of the Chief Commissioner is obtained by the income-tax authority.

If the above four conditions are satisfied, then such person cannot leave India by land, sea or air, unless he obtains a certificate in Form No. 33 from the concerned income-tax authority. Such certificate should state—

a. the person who wants to leave the country has no liabilities under Income-tax Act, or Wealth-tax Act, Gift-tax Act, Expenditure-tax Act; or

b. that satisfactory arrangements have been made for the payment of all or any of such taxes which are or may become payable by that person.

534.3 ***Clarifications from Board*** - Contractors are now not required to obtain income-tax clearance certificate from the Income-tax Department and there is no need to furnish such certificate while submitting tenders or obtaining commercial contracts. Further, income-tax clearance certificate shall also not be required for any other purposes such as registration or renewal of registration of contractors, renewal of import/export licences, renewal of post licences and renewal of shipping licences. However, all such persons shall quote their Permanent Account Number in their tender or other relevant documents—**Circular No. 2/2004**, dated February 10, 2004.

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1. In this regard, the Board has directed that tax clearance certificate, may be required to be obtained by persons domiciled in India in the following circumstances :

a. where the person is involved in serious financial irregularities and his presence is necessary in investigation of cases under the Income-tax Act or the Wealth-tax Act and it is likely that a tax demand will be raised against him, or

b. where the person has direct tax arrears exceeding Rs. 10 lakh outstanding against him which have not been stayed by any authority.

FRINGE BENEFIT TAX

Income-tax on fringe benefit [Secs. 115W to 115WL]

535. Employees enjoy many fringe benefits at the cost of the employers. In some cases, the entire expenditure incurred by the employer is taxable in the hands of the employees. In some other cases, these perquisites are taxable in the hands of the employees at concessional mode of valuation provided by rule 3. Some of them are exempt and not chargeable to tax because of specific provision under rule 3 or because of executive instructions. The Finance Minister made the following remarks in respect of these perquisites in his budget speech—

> "I have looked into the present system of taxing perquisites and I have found that many perquisites are disguised as fringe benefits, and escape tax. Neither the employer nor the employee pays any tax on these benefits which are certainly of considerable material value. At present, where the benefits are fully attributable to the employee they are taxed in the hands of the employee; that position will continue. In addition, I now propose that where the benefits are usually enjoyed collectively by the employees and cannot be attributed to individual employees, they shall be taxed in the hands of the employer. However, transport services for workers and staff and canteen services in an office or factory will be outside the tax net. The tax is not a new tax, although I am obliged to call it by a new name, namely, Fringe Benefits Tax."

535.1 ***Definition of "employer" as given in section 115W*** - For the purpose of fringe benefit tax, the term "employer" means—

a. a company;

b. a firm;

c. an association of persons or a body of individuals;

d. a local authority; and

e. every artificial juridical person, not falling within any of the above.

However, "employer" does not include (*a*) a political party, or (*b*) a person who is eligible for exemption under section 10(*23C*) or registered under section 12AA.

• The following points should be noted—

1. A person is liable for fringe benefit tax even if he does not have any income which is chargeable to income-tax. For instance, a company having only agricultural income (which is exempt under section 10) is liable for payment of fringe benefit tax if other conditions are satisfied.

2. The following cannot be "employers" for the purpose of fringe benefit tax (in other words, fringe benefit tax is not applicable in the case of following employers)—

a. an individual (whether or not books of account are audited);

b. a Hindu undivided family (whether or not books of account are audited);

c. a person whose income is eligible for exemption under section 10(*23C*) or which is registered under section 12AA;

d. Central Government;

e. a State Government;

f. a political party.

535.2 ***Clarifications given by CBDT in Circular No. 8/2005, dated August 29, 2005*** - The following propositions have been taken from **Circular No. 8/2005**, dated August 29, 2005—

1. If the company maintains separate books of account for its Indian and foreign operations, fringe benefit tax would be payable on the amount of expenses reflected in the books of account relating to the Indian operations.

If however, no separate accounts are maintained, the amount of expenses attributable to Indian operations would be the proportionate amount of the global expenditure. Further, such propor-

tionate amount shall be determined by applying to the global expenditure the proportion which the number of employees based in India bears to the total worldwide employees of the company—**Circular No. 8/2005**, dated August 29, 2005 (Question No. 20).

In other words, if an Indian company carries on business outside India but does not have any employees based in India, such company would not be liable to the fringe benefit tax in India—**Circular No. 8/2005**, dated August 29, 2005 (Question No. 21).

> ***Provisions illustrated*** - X Ltd. is an Indian company. It has business operation in India as well as in UK. It has 50 employees in India and 6 employees in UK during the previous year 2007-08. The company has incurred entertainment expenditure of Rs. 8,70,000. The company does not maintain separate books of account for Indian and overseas business operation.

X Ltd. is liable for fringe benefit tax. Value of fringe benefits pertaining to Indian operation shall be calculated as follows—

20 per cent of Rs. 8,70,000 × 50 ÷ 56

2. Fringe benefit tax will apply to foreign companies if it has employees based in India - **Circular No. 8/2005,** dated August 29, 2005 (Question No. 22). If the non-domestic company does not have employees based in India, fringe benefit tax liability is not applicable. Exemption, if any, under an Avoidance of Double Taxation Agreement is only in respect of income of the entity. However, fringe benefit tax is a liability of an entity in respect of an employer. Therefore, fringe benefit tax is payable by a non-resident employer if it has employees based in India and it fulfils other conditions given by Chapter XII-H—**Circular No. 8/2005**, dated August 29, 2005 (Question No. 23).

3. A foreign company not having any permanent establishment in India and doing business promotion through an event manager or a liaison office would not be liable to the fringe benefit tax in India if it does not have any employees based in India - **Circular No. 8/2005,** dated August 29, 2005 (Question No. 25).

4. Fringe benefit tax will apply to liaison offices of foreign companies in India if the liaison offices have employees based in India—**Circular No. 8/2005**, dated August 29, 2005 (Question No. 26).

5. In a case where a foreign company has a permanent establishment in India, fringe benefit tax is payable on the expenditure incurred or payment made for the purposes referred to in clauses (*A*) to (*P*) of section 115WB(2) and attributable to the operations of the permanent establishment of the foreign company in India irrespective of whether the expenditure attributable to the operations of the permanent establishment are incurred in India or outside India—**Circular No. 8/2005**, dated August 29, 2005 (Question No. 27).

6. A foreign company deputing personnel to India for short duration under a technical supervision contract is liable to fringe benefit tax in India if—

a. the salary, as defined in section 17, of such employees is liable to income-tax in India; or

b. the company has employees based in India other than those deputed to India for a short duration.

Further, if the foreign company incurs expenditure and claims reimbursement for such expenditure, the foreign company would be liable to fringe benefit tax on expenditure so incurred for the purposes enumerated in section 115WB(2). However, if the Indian entity bears the expenses of such personnel deputed by the foreign company and includes those expenses under the appropriate head in clauses (*A*) to (*P*) of section 115WB(2), such expenses will be subjected to fringe benefit tax in the hands of Indian entity since it is a presumptive tax—**Circular No. 8/2005**, dated August 29, 2005 (Question No. 30).

7. If a foreign company has employees based in India and the remuneration received by all its employees is not taxable in India in terms of the Article relating to dependent personal services in any treaty, such foreign companies would not be liable to fringe benefit tax in India—**Circular No. 8/2005**, dated August 29, 2005 (Question No. 31).

8. Fringe benefit tax is not payable by a trust, fund or institution if its income is exempt under section 10(*23C*) or it is registered under section 12AA. Therefore, a company registered under section 25 of

the Companies Act will also not be liable to fringe benefit tax if its income is exempt under section 10(*23C*) or such company is registered under section 12AA—**Circular No. 8/2005**, dated August 29, 2005 (Question No. 4).

9. An employer-employee relationship is pre-requisite for the levy of fringe benefit tax. An entity, which does not have any employee on its role, will not be liable for fringe benefit tax—**Circular No. 8/2005**, dated August 29, 2005 (Question Nos. 2 and 3).

10. The AAR in ***Population Council Inc., In re*** [2006] 156 Taxman 125 clarified that FBT payable under section 115WA is in addition to income-tax payable under the Act and even when no income-tax is payable by the employer on his total income computed in accordance with the provision of the Act, yet it will be liable to payment of FBT.

535.3 ***Basis of charge as given under section 115WA*** - As per section 115WA, fringe benefit tax is applicable if the following conditions are satisfied—

1. Fringe benefits are provided (or deemed to be provided) by an "employer".

2. These benefits are provided to his/its employees.

3. These benefits are provided during the previous year.

If these conditions are satisfied, the employer would be liable for fringe benefit tax. The tax will be calculated at the rate of 30 per cent (+ SC + EC + SHEC) on the "value" of fringe benefits. This is an addition to regular income-tax. Fringe benefit tax is not applicable if a person does not have any employee during the previous year.

535.4 ***Meaning of "fringe benefits" and "value of fringe benefits" as given in sections 115WB and 115WC*** - Section 115WB(1) defines "fringe benefits" which are narrated in *Column 1* of Part A of the table given below. Section 115WB(2) defines "deemed fringe benefits" which are given in *Column 1* of Part B of the table. Section 115WC defines "value of fringe benefits". These values are given in *Column 2* of Parts A and B of the table. Fringe benefit tax liability is calculated at the rate of 30 per cent (+ SC + EC + SHEC) of the value given in *Column 2*—

Part A	
'Fringe benefits', as per section 115WB(1), means any consideration for employment provided by way of—	***Value as per section 115WC***
Any privilege, service, facility or amenity, directly or indirectly, provided by an employer, whether by way of reimbursement or otherwise, to his employees (including former employees) [not being expenses mentioned in *Note 1*]	No value given
Any free or concessional ticket provided by the employer for private journeys of his employees or their family members	100% (cost at which the same benefit is provided to the general public) *minus* any recovery from the employee
Any contribution by the employer to an approved superannuation fund for employees	100% [from the assessment year 2007-08, 100% of the amount in excess of Rs. 1,00,000 for each employee]
Any specified security or sweat equity shares allotted or transferred, directly or indirectly, by the employer free of cost or concessional rate to his employee (including former employees)	100 per cent (of the fair market value of the specified security or sweat equity shares on the date on which option vests with the employee *minus* the amount actually paid by or recovered from the employee) (applicable from the assessment year 2008-09 and taxable in the hands of the employer

'Fringe benefits', as per section 115WB(1), means any consideration for employment provided by way of—	*Value as per section 115WC*
	in the year in which shares are allotted/transferred by the employer to the employee) [*see* para 535.5 for detailed discussion].
Part B	
Deemed fringe benefits [the following shall be deemed to have been provided by the employer to his employees if the employer has in the course of his business and profession (whether or not such activity is carried on with the object of deriving income) incurred these expenses] as per section 115WB(2)	*Value as per section 115WC*
Entertainment	20%
Provision of hospitality of every kind by the employer to any person, whether by way of provision of food or beverages or in any other manner whatsoever and whether or not such provision is made by reason of any express or implied contract or custom or usage of trade (but does not include any expenditure on, or payment for, food or beverages provided by the employer to his employees in office or factory and any expenditure on or payment through paid vouchers which are not transferable and usable only at eating joints or outlets)	20% (for concessional rate, *see* table *infra*)
Conference (not being fee for participation by the employees in any conference) [Any expenditure on conveyance, tour and travel (including foreign travel), on hotel, or boarding and lodging in connection with any conference shall be deemed to be expenditure incurred for the purposes of conference]	20%
Sales promotion including publicity (not being the expenditure mentioned in *Note 2*)	20%
Employees' welfare (not being any expenditure incurred or payment made to fulfil any statutory obligation or mitigate occupational hazards or provide first aid facilities in the hospital or dispensary run by the employer)	20%
Conveyance	20% (for concessional rate, *see* table *infra*)
Use of hotel, boarding and lodging facilities	20% (for concessional rate, *see* table *infra*)
Repair, running (including fuel), maintenance of motorcars and the amount of depreciation thereon	20% (for concessional rate, *see* table *infra*)
Repair, running (including fuel) and maintenance of aircrafts and the amount of depreciation thereon	20% (for concessional rate, *see* table *infra*)
Use of telephone (including mobile phone) other than expenditure on leased telephone lines	20%
Maintenance of any accommodation in the nature of guest house (other than accommodation used for training purposes) (applicable for the assessment years 2006-07 to 2008-09; not applicable from the assessment year 2009-10)	0% (20% for the assessment years 2006-07 to 2008-09)
Festival celebrations	20% (50% for the assessment years 2006-07 to 2008-09)
Use of health club and similar facilities	50%

Deemed fringe benefits [the following shall be deemed to have been provided by the employer to his employees if the employer has in the course of his business and profession (whether or not such activity is carried on with the object of deriving income) incurred these expenses] as per section 115WB(2)	*Value as per section 115WC*
Use of any other club facilities	50%
Gifts	50%
Scholarships	50%
Tour, travel, foreign travel (from the assessment year 2007-08)	5%

Value of fringe benefit at concessional rate

Heads	*Hotel*	*Cons-truction*	*Pharma*	*Software*	*Carriage of passenger/ goods by*			*Any other*
					Car	*Air*	*Ship*	
Hospitality [Sec. 115WB(2)(B)]	5% (5%)	20% (20%)	20% (20%)	20% (20%)	20% (20%)	20% (5%)	20% (5%)	20% (20%)
Conveyance [Sec. 115WB(2)(C)]	20% (20%)	5% (5%)	5% (5%)	5% (5%)	20% (20%)	20% (20%)	20% (20%)	20% (20%)
Tour, travel, foreign travel [Sec. 115WB(2)(Q)]	20% (5%)	5% (5%)	5% (5%)	5% (5%)	20% (5%)	20% (5%)	20% (5%)	20% (5%)
Hotel, boarding/lodging [Sec. 115WB(2)(G)]	20% (20%)	20% (20%)	5% (5%)	5% (5%)	20% (20%)	20% (5%)	20% (5%)	20% (20%)
Car maintenance [Sec.115WB(2)(H)]	20% (20%)	20% (20%)	20% (20%)	20% (20%)	5% (5%)	20% (20%)	20% (20%)	20% (20%)
Aircraft maintenance [Sec.115WB(2)(I)]	20% (20%)	20% (20%)	20% (20%)	20% (20%)	20% (20%)	0% (0%)	20% (20%)	20% (20%)

Figures in brackets are applicable from the assessment year 2007-08 onwards

Note 1 - The privilege, service, facility or amenity does not include perquisites in respect of which tax is paid or payable by the employee. Further, it does not include (from the assessment year 2007-08) any benefit or amenity in the nature of free or subsidised transport or any such allowance provided by the employer to his employees for journeys by the employees from their residence to the place of work or such place of work to the place of residence. The transportation cost incurred in providing the transportation facility for movement of offshore employees from their residence in home countries (outside India) to the place of work (rig in India) and back is not liable to fringe benefit tax—***R & B Falcon (A)(P.) Ltd.*** v. ***CIT*** [2008] 169 Taxman 515 (SC).

Note 2 - The following expenditure on advertisement shall not be taken as "deemed fringe benefit"—

a. the expenditure (including rental) on advertisement of any form in any print (including journals, catalogues or price lists) or electronic media or transport system;

b. the expenditure on the holding of, or the participation in, any press conference or business convention, fair or exhibition;

c. the expenditure on sponsorship of any sport event or any other event organized by any Government agency or trade association or body;

d. the expenditure on the publication in any print or electronic media of any notice required to be published by or under any law or by an order of a court or tribunal;

e. the expenditure on advertisement by way of signs, art work, painting, banners, awnings, direct mail, electric spectaculars, kiosks, hoardings, bill boards or by way of such other medium of advertisement;

f. the expenditure by way of payment to any advertising agency for the purposes of (*a*) to (*e*) above; and

g. the expenditure on distribution of free samples of medicines or of medical equipment, to doctors (from the assessment year 2007-08); and

h. the expenditure by way of payment to any person of repute for promoting the sale of goods or services of the business of the employer (from the assessment year 2007-08).

535.4-1 *FREE OR CONCESSIONAL TICKETS [SEC. 115WB(1)(b)]* - It includes free or concessional tickets given by a transport undertaking to its employees and family members. It is not applicable if such tickets are given by an employer who is not engaged in the business of transport undertaking. Leave travel assistance or leave travel concession given by an employer to his employees is not covered by section 115WB(1)(*b*)—**Circular No. 8/2005**, dated August 29, 2005 (Question No. 46).

In respect of transport facility provided by a transport undertaking to its employees, the value of fringe benefit shall be calculated at "cost" of which the same benefit is provided by the employer to the public as reduced by the amount, if any, paid by, or recovered from his employees. The cost at which the ticket is provided by the employer to the general public shall be the price of the ticket which an ordinary passenger is expected to pay on the date of purchase of the ticket for the date, time and the class of travel. Similarly, in a case where an open ticket is issued a number of days in advance but the reservation is generally confirmed a few hours before departure, the value of the free or concessional ticket shall be the cost of the ticket which an ordinary passenger seeking reservation a few hours before departure is liable to pay as reduced by the amount, if any, paid by or recovered from the employees—**Circular No. 8/2005**, dated August 29, 2005 (Question No. 45).

535.4-2 *APPROVED SUPERANNUATION FUND [SEC. 115WB(1)(c)]* - Employers' contribution to an approved superannuation fund (in excess of Rs. 1,00,000 per employee), is subject to fringe benefit tax. However, employers' contribution to gratuity fund/provident fund is not subject to fringe benefit tax.

535.4-3 *ENTERTAINMENT [SEC. 115WB(2)(A)]* - It does not include fixed entertainment allowance given to employees/directors. However, it includes the following—

1. Reimbursement of entertainment expenditure by an employer to employees/directors/others.

2. Expenditure on meeting/get togethers of employees and their family members on non-festival occasions including annual day.

535.4-4 *PROVISION OF HOSPITALITY [SEC. 115WB(2)(B)]* - It includes the following—

1. Expenditure on food/meals incurred by employees and later on reimbursed by employer (even if such expenditure is incurred by employees in office after duty hours).

2. Expenditure on food and beverages provided by employer at a training centre taken on hire by employer.

▪ It does not include the following—

1. Fixed lunch allowance/refreshment allowance.

2. Expenditure on, or payment for, food or beverages provided by the employer to his employees in office or factory.

3. Any expenditure on or payment through paid vouchers which are not transferable and usable only at eating joints or outlets.

4. Any expenditure on or payment through non-transferable pre-paid electronic meal card usable only at eating joints or outlets and satisfies prescribed conditions (applicable from the assessment year 2009-10).

5. Expenditure on food and beverages provided by employer at its own training centre to employees.

535.4-5 ***CONFERENCE [SEC. 115WB(2)(C)]*** - It includes the following—

1. Expenditure on attending training programmes organized by trade bodies.

2. Expenditure on conferences for agents/dealers/development advisor.

▪ It does not include the following—

1. Fixed conference allowance to employees/directors.

2. Fees for participation by employees in any conference (excluding travelling, boarding and lodging expenses).

3. Expenditure on in house training of employees (excluding travelling, boarding and lodging expenses).

535.4-6 ***SALES PROMOTION [SEC. 115WB(2)(D)]*** - It includes the following—

1. Payment for use of brand/brand ambassador/celebrity endorsement (from the assessment year 2007-08, not being a payment to a person of repute for promoting sales).

2. Expenditure on free samples of products distributed to trade or consumers (from the assessment year 2007-08, it does not include free sample of medicines/medical equipment to doctors) (from the assessment year 2008-09, expenditure on free or concessional samples to any person will not be subject to fringe benefit tax).

3. Expenditure on free offers (with products) such as freebies like tattoos, cricket cards or similar products, to trade or consumers.

4. Expenditure on product marketing research carried on through its own employees.

▪ It does not include the following—

1. Expenditure (including rental) on advertisement of any form in any print (including journals, catalogues or price lists) or electronic media or transport system.

2. Expenditure on the holding of, or the participation in, any press conference or business convention, fair or exhibition.

3. Expenditure on sponsorship of any sports event or any other event organized by any Government agency or trade association or body.

4. Expenditure on the publication in any print or electronic media of any notice required to be published by or under any law or by an order of a court or tribunal.

5. Expenditure on advertisement by way of signs, art work, painting, banners, awnings, direct mail, electric spectaculars, kiosks, hoardings, bill boards or display of products, or by way of such other medium of advertisement.

6. Expenditure by way of payment to any advertising agency for the above purposes.

7. Brokerage and selling commission paid for selling goods.

8. Expenditure relating to salesmen appointed by distributors for companies' products reimbursed through credit notes.

9. Sale discount to wholesellers/customers or bonus points to customers.

10. Expenditure on incentives given to distributors for meeting quantity targets.

11. Expenditure on product marketing research paid to an outside agency.

12. Expenditure in the nature of call centre charges for canvassing sales (cold calls) or carrying out post sales activities.

13. Expenditure on making ad-film.

535.4-7 ***EMPLOYEES' WELFARE [SEC. 115WB(2)(E)]*** - It includes the following—

1. Payment for group personal accident/workman compensation insurance not under a statutory obligation.

2. Medical expenditure reimbursement up to Rs. 15,000.

3. Expenditure on garden, site cleaning, light decoration etc. in employees colony.

4. Expenditure on group health insurance not under a statutory obligation.

5. Expenditure at a hospital/dispensary for injuries incurred during course of employment (hospital not run by employer) not under a statutory obligation.

6. Subsidy provided to a school not meant exclusively for employees' children.

7. Reimbursement of expenditure on books/periodicals to employees.

8. Expenditure incurred on prizes/awards to employees.

9. Expenditure on providing transport facility to employees' children.

10. Expenditure on meeting/get togethers of employees and their family members on non-festival occasions including annual day.

▪ It does not include the following—

1. Any expenditure incurred or payment made to fulfil any statutory obligation.

2. Any expenditure incurred or payment made to mitigate occupational hazards.

3. Any expenditure incurred or payment made to provide first aid facilities in a hospital or dispensary run by the employer.

4. Expenditure incurred to or payment made to provide creche facility for the children of the employee (applicable from the assessment year 2009-10).

5. Expenditure incurred to or payment made to sponsor a sportsman, being an employee (applicable from the assessment year 2009-10).

6. Expenditure incurred to or payment made to organise sports events for employees (applicable from the assessment year 2009-10).

7. Providing free or subsidized transport for journeys to employees from their residence to the place of work.

8. Payment for group personal accident/workman compensation insurance under a statutory obligation.

9. Medical expenditure reimbursement above Rs. 15,000.

10. Expenditure on group health insurance under a statutory obligation.

11. Expenditure at a hospital/dispensary for injuries incurred during course of employment (hospital run by employer).

12. Expenditure at a hospital/dispensary for injuries incurred during course of employment (hospital not run by employer) under a statutory obligation.

13. Employers' contribution towards recognised provident fund/approved gratuity fund.

14. Employers' contribution towards unrecognised provident fund/unapproved gratuity fund.

15. Fixed medical allowance.

16. Fixed lunch allowance.

17. Expenditure on providing rent-free house or house at concessional rent to employees.

18. Fixed allowances exempt under section 10(*14*).

535.4-8 *CONVEYANCE, TOUR AND TRAVEL [SEC. 115WB(2)(F)/(o)]* - It includes the following—

1. Reimbursement of car expenses including driver salary to employees on the basis of declaration or on the basis of bills submitted by employees.

2. Travelling expenditure/conveyance expenditure/tour or travel expenditure incurred in respect of a project assigned by a client which is later on reimbursed by the client.

3. Per-diem allowances for meeting lodging and boarding given to employees.

▪ It does not include the following—

1. Reimbursement of travelling expenditure/conveyance expenditure/tour or travel expenditure to a consultant in respect of a project assigned to him.

2. Fixed conveyance allowance/travelling allowance/transport allowance given to employees/director.

3. Expenditure for providing leave travel concession (LTC) to employees.

535.4-9 ***HOTEL, BOARDING, LODGING [SEC. 115WB(2)(G)]*** - It includes any expenditure on use of hotel, boarding and lodging facilities (whether it is incurred for employees or any other person). It also includes reimbursement of hotel bills to employees/directors. However, it does not include fixed hotel allowance to employees/directors.

535.4-10 ***REPAIR, RUNNING AND MAINTENANCE OF CARS [SEC. 115WB(2)(H)]*** - It includes the following—

1. Expenditure on repair of motor car.

2. Expenditure on running of motor car including fuel.

3. Maintenance expenditure of motor car.

4. Depreciation of motor car (as per Income-tax Act).

5. Lease rent of motor car.

6. Salary paid to drivers of motor cars.

7. Rent of garage for motor cars.

8. Interest on loan taken to purchase motor cars.

▪ It does not include any expenditure on running, maintenance of delivery vans, display vans, lorries, ambulances, tractors, buses, trucks, tempos, etc.

535.4-11 ***REPAIR, RUNNING AND MAINTENANCE OF AIRCRAFTS [SEC. 115WB(2)(I)]*** - It includes the following—

1. Expenditure on repair of aircrafts.

2. Expenditure on running of aircrafts including fuel.

3. Maintenance expenditure of aircrafts.

4. Depreciation of aircrafts (as per Income-tax Act).

5. Lease rent of aircrafts.

6. Salary paid to pilots of aircrafts.

7. Rent of garages parking slots or airport tarmac or hanger.

8. Interest on loan taken to purchase aircrafts.

535.4-12 ***TELEPHONE [SEC. 115WB(2)(J)]*** - It includes any expenditure on use of telephone including mobile phones (installed anywhere). However, it does not include the following—

1. Any expenditure on leased telephone line.

2. Fixed telephone allowance to employees.

535.4-13 ***GUEST HOUSE [SEC. 115WB(2)(K)]**** - "Guest house" has not been defined. According to the Madras High Court unless the "guest house" is intended for use by a complete stranger, it cannot be called a guest house to fall within section 115WB(2)(*K*)—*CIT* v. *Aruna Sugar Ltd.* [1980] 123 ITR 619 (Mad.).

Guest house maintenance expenditure includes the following—

1. Expenditure on provision of food in guest house.

2. Contact changes paid to guest house staff.

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*Expenditure on maintenance of guest house is subject to FBT only up to the assessment year 2008-09.

3. Rent of guest house.

4. Any other expenditure on maintenance of guest house/holiday home.

■ It does not include the following—

1. Expenditure on items like refrigerators, televisions, furnitures in guest house.

2. Depreciation of guest house.

3. Maintenance expenditure of guest house used for training purposes.

535.4-14 *FESTIVAL CELEBRATION [SEC. 115WB(2)(L)]* - It includes any festival celebration expenditure, *e.g.*, expenditure on meeting/get togethers of employees and their family members on the occasion of any festival like 'Navratra', 'Diwali', 'Id', 'Christmas' or 'New Year'. However, it does not include expenditure on celebration on Independence Day and Republic Day.

535.4-15 *HEALTH CLUB [SEC. 115WB(2)(M)]* - It includes any expenditure on providing health club facility. It includes the following—

1. Reimbursement of health club expenditure to employees/directors.

2. Payment of entrance fees.

■ It does not include the following—

1. Depreciation on club building.

2. Fixed club allowance to employees/directors.

535.4-16 *ANY OTHER CLUB FACILITY [SEC. 115WB(2)(N)]* - It includes any expenditure on providing any other club facility. It includes the following—

1. Payment for entrance fees to a club.

2. Reimbursement of club expenditure to employees.

■ It does not include the following—

1. Depreciation on club building.

2. Fixed club allowance to employees/directors.

535.4-17 *GIFT [SEC. 115WB(2)(O)]* - It includes the following—

1. Expenditure on gift in kind

2. Expenditure on gift in cash

3. Expenditure on gift under trade schemes or promotion of company's product to distributors/ retailers

4. Expenditure on gift to customers

5. Expenditure on gift to employees on occasion like marriage

6. Expenditure on giving any gift to any other person.

535.4-18 *SCHOLARSHIP [SEC. 115WB(2)(P)]* - It includes the following—

1. Expenditure on training of employees in an educational institute

2. Scholarship awarded to students and trainees

3. Any other scholarship.

535.4-19 *OTHER PROPOSITIONS TAKEN FROM CIRCULAR NO. 8/2005, DATED AUGUST 29, 2005* - The following propositions have been taken from **Circular No. 8/2005**, dated August 29, 2005—

■ *"Employer" is a must* - Fringe benefit tax is payable by an entity if it is an employer. There is no presumption in law regarding an entity being an employer. Therefore, whether an entity is an employer or not is rebuttable.

■ *No segregation as 'expenses incurred on employees' or 'expenses incurred on others'* - Under section 115WB(2), fringe benefits shall be deemed to have been provided by the employer to his employees, if the conditions specified therein are satisfied. Hence, if the employer has incurred any expense for

any one of the purposes enumerated in clauses (*A*) to (*P*) of section 115WB(2), the whole of that expense falling under the relevant head shall be deemed to have been provided. No segregation as 'expenses incurred on employees' or 'expenses incurred on others' is permissible - **Circular No. 8/2005**, dated August 29, 2005 (Question No. 14). There is no requirement to segregate the various expenses referred to in section 115WB, between those incurred for official purposes and personal purposes—**Circular No. 8/2005**, dated August 29, 2005 (Question No. 15).

■ *Capital or revenue expenditure* - Fringe benefit tax is payable in the year in which the expenditure is incurred irrespective of whether the expenditure is capitalized or not. However, the same expenditure will not be liable to fringe benefit tax again in the year in which it is amortized and charged to profit—**Circular No. 8/2005**, dated August 29, 2005 (Question No. 19).

■ *Pre-operative expenses* - Any expenditure incurred for the purposes referred to in clauses (*A*) to (*P*) of section 115WB(2) is liable to fringe benefit tax irrespective of whether such expenditure is incurred prior to commencement of the business or thereafter—**Circular No. 8/2005**, dated August 29, 2005 (Question No. 16).

■ *Expenditure to be calculated on "due" basis* - Fringe benefit tax would be payable in the year in which the expenditure is incurred. Therefore, fringe benefit tax would not be payable on payment of advance towards expenses to be incurred in the future. In other words, expenditure would be considered on due basis (not on payment basis)—**Circular No. 8/2005**, dated August 29, 2005 (Question No. 18).

■ *Net expenses to be considered in case of recovery from employees* - Where the employer recovers from its employees, any amount of expenditure incurred for the purposes listed in clauses (*A*) to (*P*) of section 115WB(2), the value of the fringe benefits shall be determined with reference to the net expenditure and not gross expenditure—**Circular No. 8/2005**, dated August 29, 2005 (Question No. 32).

■ *Costing sharing agreement with group companies* - At times, an employer could have cost sharing agreement with its group companies wherein a particular item of cost will be shared in an agreed proportion. In such a case, for administrative convenience, the employer may pay for the total cost and claim reimbursement from other group companies. In such a case a problem arises whether the employer making the payment is liable to fringe benefit tax on the whole amount or only in respect of his share.

The share of each of the group companies in the total expenditure is the expenditure incurred by the respective company though the payment is made by one company. Hence, the company making the payment shall be liable for fringe benefit tax only in respect of its share. Similarly, the other group companies will be liable to fringe benefit tax in respect of their respective shares—**Circular No. 8/2005**, dated August 29, 2005 (Question No. 33).

■ *Disallowance under sections 37, 40, 40A and 43B* - Any expenditure which is disallowed under sections 37, 40, 40A and 43B shall not be considered for the purpose of fringe benefit tax—**Circular No. 8/2005**, dated August 29, 2005 (Question No. 35).

■ *Bogus expenditure* - Bogus expenditure is not deductible under section 37. Consequently, such expenses are not subject to fringe benefit—**Circular No. 8/2005**, dated August 29, 2005 (Question No. 8).

■ *Fringe benefit tax in the case of depreciation* - Depreciation of cars and aircrafts is liable for fringe benefit tax by virtue of section 115WB(2)(*H*)/(*I*). In this respect the following points should be noted—

1. Depreciation for the above purpose shall be calculated according to the provisions of section 32 —**Circular No. 8/2005**, dated August 29, 2005 (Question No. 83).

2. For the purposes of payment of advance tax on fringe benefits, tax depreciation should be taken on a *pro rata* basis for payment of advance fringe benefit tax—**Circular No. 8/2005**, dated August 29, 2005 (Question No. 37).

• *Reimbursement of expenditure by client* - If the expenditure is incurred by an "employer" and it is later on reimbursed by client, the employer will be subject to fringe benefit tax (not the client)—**Circular No. 8/2005**, dated August 29, 2005 (Question No. 12/13).

• *Accounting records* - There are no special requirements for accounting records under the fringe benefit tax. However, the Institute of Chartered Accountants of India have advised Government that they will be issuing separate Accounting Standards to facilitate compliance with the provisions of the fringe benefit tax—**Circular No. 8/2005**, dated August 29, 2005 (Question No. 42).

535.5 *Employees' stock option plan [Sec. 115WB(1)(d)]* - Stock option plan is subject to fringe benefit tax as follows—

■ Employees' stock option benefit will be taxable in the hands of employer under fringe benefit tax.

■ It will be taken as a fringe benefit provided by the employer to its employees. Clause (*d*) has been inserted in section 115WB(1) for this purpose from the assessment year 2008-09.

■ The aforesaid clause (*d*) shall be applicable if any specified security or sweat equity shares are allotted or transferred by the employer directly or indirectly on or after April 1, 2007 to its employees or former employees. Clause (*d*) will be applicable regardless of the fact whether stock option plan is offered to the employees free of cost or at concessional rate.

■ For the purpose of section 115WC, value of fringe benefits would be 100 per cent of fair market value of the specified security or sweat equity on the date on which the option vests with the employee as reduced by the amount actually paid by or recovered from the employee in respect of such security or shares.

■ The aforesaid fringe benefit would be taxable at the rate of 30 per cent *plus* surcharge, education cess and secondary and higher education cess. However, it is taxable in the year in which shares or securities are allotted or transferred by the employer to the employee.

■ Employees will be taxable at the time of transfer of the aforesaid securities. Capital gain will be calculated by deducting the fair market value from the sale consideration. In the case of stock option plan which has been issued in accordance with the guidelines issued by the Central Government, the aforesaid tax liability will be attracted even at the time of gift of specified securities by the employee.

■ Section 115WKA has been inserted from the assessment year 2008-09 for the purpose of recovering fringe benefit tax by the employer in respect of sweat equity shares, etc., from employees. If sweat equity shares are allotted or transferred, directly or indirectly, by an employer on or after April 1, 2007, it shall be lawful for the employer to vary the agreement or scheme under which such specified security or sweat equity shares has been allotted or transferred. The agreement or scheme can be modified so as to recover from the employee the fringe benefit tax to the extent to which such employer is liable to pay the fringe benefit tax in relation to the value of fringe benefits provided to the employee and determined under the above modified provisions.

535.5-1 *VALUATION OF SPECIFIED SECURITY OR SWEAT EQUITY SHARE* - Rule 40C has been inserted which provides the following guidelines—

■ *Quoted shares* - In a case where, on the date of the vesting of the option, the share in the company is listed on a recognized stock exchange in India, the fair market value shall be the average of the opening price and closing price of the share on that date on the said stock exchange. Where, however, on the date of vesting of the option, the share is listed on more than one recognized stock exchanges, the fair market value shall be the average of opening price and closing price of the share on the recognised stock exchange which records the highest volume of trading in the share. Where on the date of vesting of the option, there is no trading in the share on any recognized stock exchange, the fair market value shall be the closing price of the share on any recognised stock exchange on a date closest to the date of vesting of the option and immediately preceding such date.

For this purpose "closing price" of a share on a recognised stock exchange on a date shall be the price of the last settlement on such date on such stock exchange. Where the stock exchange quotes both "buy" and "sell" prices, the closing price shall be the "sell" price of the last settlement. "Opening price"

of a share on a recognised stock exchange on a date shall be the price of the first settlement on such date on such stock exchange. Where the stock exchange quotes both "buy" and "sell" prices, the opening price shall be the "sell" price of the first settlement.

■ *Unquoted shares* - In a case where, on the date of vesting of the option, the share in the company is not listed on a recognized stock exchange, the fair market value shall be such value of the share in the company as determined by a merchant banker on the specified date. "Specified date" means the date of vesting of the option; or any date earlier than the date of the vesting of the option, not being a date which is more than 180 days earlier than the date of the vesting.

535.5-2 ***PROPOSITIONS TAKEN FROM CIRCULAR NO. 9/2007*** - The Board has issued Circular No. 9/2007 dated December 20, 2007. The following propositions have been taken from the aforesaid Circular—

■ *Shares allotted by a foreign holding company to the employees of its Indian subsidiary company* - FBT would be payable by Indian subsidiary company.

■ *In the above case, there is no charge back of cost by the foreign holding company* - Even then FBT would be payable by Indian subsidiary company.

■ *Shares allotted by a foreign holding company to the employees of its Indian subsidiary company and shares were allotted when the employee was outside India* - FBT would be payable by the Indian subsidiary company only if the employee was based in India during the "grant period" (*i.e.*, the period commencing on the date of grant and ending on the date of vesting). If such employee was based in India only for some time during the "grant period", then proportionate amount is chargeable to tax.

■ *Shares allotted by a foreign company to an employee who is deputed to work in India in the year of such allotment* - FBT would be payable by foreign company only if the employee was based in India during the "grant period". If such employee was based in India only for some time during the "grant period", then proportionate amount is chargeable to tax.

■ *Cost of acquisition of such shares in the hands of employee* - Fair market value on the date on which the option vests with the employee is taken as cost of acquisition (amount recovered from employee by way of FBT or sale price of shares as well as calculation of proportionate value, when an employee is in India during a part of "grant period" will not be considered).

■ *Where FBT, on account of shares allotted under ESOPs, has been paid by the employer and subsequently recovered from employee, can such employee claim credit in a foreign country for this FBT paid by the employer in India* - It will be taken as tax paid by employee and such employee can claim credit, in a foreign country, for the FBT, on account of shares allotted or transferred under ESOPs, paid by the employer in India. Section 115WKB has been inserted for this purpose.

■ *Shares allotted under ESOP to employee, employer does not want to pay FBT, employee wants to pay tax on perquisite under section 17* - It is not possible. There is no option to the employer. Employer will have to pay FBT.

■ *Shares allotted under ESOP to employee, amount recovered from employee is more than fair market value on the date when the option vests with the employee* - No FBT.

■ *Shares are not listed in a recognized stock exchange in India but are listed on any globally recognised stock exchange - What will be the valuation methodology* - Treated as unlisted shares. Category 1 - Merchant banker (registered with SEBI) will have to determine FMV. However, if the shares are listed in any globally recognised stock exchange, the merchant banker shall use the listed price as one of the basis for valuation and recommend the best value.

■ *Status of independent valuation carried by a foreign merchant banker/other experts in the case of unlisted shares* - Category 1 - Merchant banker (registered with SEBI) will have to determine FMV. It is mandatory.

■ *When there exists different methods for valuing FMV for unlisted companies, which method should be used by the merchant bankers to determine the FMV* - The Merchant Banker should determine the FMV on the basis of alternative methods and recommend the most appropriate value.

■ *What is the FMV that a company should adopt if the shares have been valued by more than one merchant banker or by one merchant banker on more than one occasion* - Value on the specified date, which is closest to the date of the vesting of the option, should be adopted, if the shares have been valued by more than one Merchant Banker or by one Merchant Banker on more than one occasion.

■ *Whether the fringe benefit arising on account of shares allotted or transferred under an ESOP is allowed as deduction in calculating the taxable income of the employer company* - If the employer purchases the shares and then subsequently transfers such shares to its employees, the expenditure so incurred is allowable as deduction in computing the taxable income of the employer company. However, if the shares are allotted to the employees from the share capital of the company, nothing is deductible.

■ *ESOP issued to non-employees* - No FBT. Recipient will have to pay tax.

■ *When there is different date of vesting for different lots and shares are transferred by employees as one lot* - FIFO will be followed to calculate FMV for the purpose of fringe benefit tax.

■ *Whether it is binding upon the Assessing Officer to accept the valuation made by the merchant banker* - It is binding upon the Assessing Officer to accept the valuation made by the Merchant Banker unless the valuation by such banker is perverse.

■ *How would the recovery of FBT be treated in the hands of the employer* - Since FBT is not an allowable deduction in computation of the income of the employer, any recovery of FBT will not be treated as income in his hands.

■ *What should be the mechanism and timing of recovery of FBT* - The law does not provide for any specific mechanism or timing of recovery of FBT.

■ *Is it lawful for the employer to recover FBT with respect to ESOPs granted prior to April 1, 2007* - It would be lawful for the employer to recover FBT with respect to ESOPs granted prior to April 1, 2007, but allotted or transferred to the employee after such date.

■ *What will be the date of allotment of an Employee Stock Option* - The date of allotment of an Employee Stock Option shall be the date on which the underlying asset is allotted or transferred to the employee.

■ *Whether the FBT recovered from the employee would form the cost basis for employee for calculating capital gain on subsequent sale of shares* - No. The recovery of FBT from the employee by the employer will not change the cost of acquisition of the shares in the hand of the employee.

535.5-3 CONDITIONAL ESOP - An employer is liable for FBT in the year in which sweat shares are allotted or transferred to an employee. If shares allotted to employees are subject to lock-in-period (during lock-in-period shares cannot be transferred/pledged and if the employee resigns during the lock-in-period, shares are to be re-transferred to the employer), FBT liability cannot be attracted till the lock-in-period expires. This view is based upon the ruling of Supreme Court in the case of ***CIT*** v. ***Infosys Technologies Ltd.*** [2008] 166 Taxman 204.

535.5-4 STOCK APPRECIATION RIGHTS - Stock appreciation rights are not subject to fringe benefit tax under section 115WB(1)(*d*) as allotment or transfer of shares to employees is not involved.

Stock appreciation rights are all about evaluating the performance of employees in the light of increase in share prices of the company and on that basis a cash bonus is given to employees. Cash bonus is taxable in the hands of employees under section 15 read with section 17(1)(*i*).

535.5-5 CASE STUDIES - The following case studies are given to have better understanding of the above provisions—

535.5-5P1 A Ltd. gives the following information—

Date when X joins A Ltd.	*January 14, 2001*
Date of granting the option	*April 1, 2004*
Date of vesting of the option	*April 1, 2007*
What is the option	*To purchase 1,000 shares in A Ltd. at pre-determined price of Rs. 90 per share at any time during April 1, 2007 and March 31, 2016*
'Grant period'	*April 1, 2004 to April 1, 2007*
Date of exercise of option	*March 30, 2008 (to purchase only 900 shares)*
Date of allotment	*April 1, 2008*
FBT applicable	*Since shares are allotted on or after April 1, 2007, FBT is applicable, if X is based in India at any time during the 'grant period'. Employer/employee do not have any option*

SOLUTION :

FBT computation if FMV on April 1, 2007 is Rs. 600 per share and during the 'grant period' X is based in India only for 6 months.

FMV of 900 shares on the date of vesting	Rs. 5,40,000
Less: Amount paid by X	Rs. 81,000
Balance	Rs. 4,59,000
'Grant period'	3 years
Out of which X is based in India	½ year
FBT liability of A Ltd. (AY 2009-10)	33.99% of 4,59,000 × ½ ÷ 3 = Rs. 26,002

Capital gains computation in the hands of X

Period of holding of shares in the hands of X	From April 1, 2008 till the date of transfer
Cost of acquisition in the hands of X	Rs. 600 per share (amount paid by X to the employer either by way of payment of price or payment of FBT will not be considered)
Out of 900 shares, 200 shares are transferred at Rs. 2,000 per share on January 1, 2009 at BSE	Short-term capital gain [200 (Rs. 2,000 —Rs. 600)] = Rs. 2,80,000 taxable under section 111A at the rate of 15% (+ SC + EC + SHEC)
300 shares are transferred at Rs. 2,600 per share on April 10, 2009 at BSE	Long-term capital gain not taxable under section 10(38)

535.5-5P2 B Ltd. gives the following information —

Date when Y joins B Ltd.	*September 1, 1995*
Date of granting the option	*January 1, 2003*
Date of vesting of the option	*December 31, 2006*
'Grant period'	*January 1, 2003 to December 31, 2006*
What is the option	*To purchase at the option of Y, 4,000 shares in B Ltd. at pre-determined price of Rs. 100 per share at any time during December 31, 2006 and December 31, 2009*
Date of exercise of option	*March 30, 2008 (to purchase only 3,000 shares)*
Date of allotment (on the allotment Y is based in India)	*April 1, 2008*
Date when credited in the demat account of Y	*April 4, 2008*

How many days Y was based in India during the grant period	Case 1 - *January 1, 2003 to December 31, 2006* Case 2 - *Not based in India at all during the grant period* Case 3 - *Only for 10 months*
Fair market value on the date of vesting, i.e., December 31, 2006	Situation 1 - *Rs. 70* Situation 2 - *Rs. 270*
Fair market value on the date of allotment, i.e., April 1, 2008	*Rs. 700*

SOLUTION :

Value of fringe benefit

	Situation 1 (FMV: Rs. 70) (pre-determined price Rs. 100)	Situation 2 (FMV: Rs. 270) (pre-determined price Rs. 100)
Case 1 (based in India 4 years, grant period 4 years)	Nothing is taxable as fair market value *minus* pre-determined price is negative	4 ÷ 4 × [(Rs. 270 — Rs. 100) × 3,000] = Rs. 5,10,000
Case 2 (based in India 0, grant period 4 years)	Nothing is taxable as fair market value *minus* pre-determined price is negative	Nothing is taxable as the employee was not based in India at all during the grant period even if he is based in India at the time of allotment
Case 3 (based in India 10 months, grant period 48 months)	Nothing is taxable as fair market value *minus* pre-determined price is negative	10 ÷ 48 × [(Rs. 270 — Rs. 100) × 3,000] = Rs. 1,06,250

FBT is applicable in (a) Case 1, Situation 2, and (b) Case 3, Situation 2. Fringe benefit tax liability will be as follows -

	If Y Ltd. is a domestic company	If Y Ltd. is a non-resident company
Case 1, Situation 2	33.99% of Rs. 5,10,000 = Rs. 1,73,349	31.6725% of Rs. 5,10,000 = Rs. 1,61,530
Case 3, Situation 2	33.99% of Rs. 1,06,250 = Rs. 36,114	31.6725% of Rs. 1,06,250 = Rs. 33,652

Cost of acquisition in the hands of Y for the purposes of computation of capital gain

	Situation 1 (FMV: Rs. 70) (pre-determined price Rs. 100)	Situation 2 (FMV: Rs. 270) (pre-determined price Rs. 100)
Case 1 (based in India 4 years, grant period 4 years)	Rs. 70	Rs. 270
Case 2 (based in India 0, grant period 4 years)	Rs. 70	Rs. 270
Case 3 (based in India 10 months, grant period 48 months)	Rs. 70	Rs. 270

Note - In *Situation 1* cost of acquisition will be Rs. 70 per share even if amount paid by Y to get the shares allotted is Rs. 100 per share. Likewise, in *Situation 2* fair market value of Rs. 270 per share will be the cost of acquisition.

Computation of short-term capital gain if Y transfers 2,100 shares on September 1, 2008 at the rate of Rs. 1,950 per share

	Situation 1 (FMV: Rs. 70) (pre-determined price Rs. 100)	Situation 2 (FMV: Rs. 270) (pre-determined price Rs. 100)
Case 1 (based in India 4 years, grant period 4 years)	2,100 × (Rs. 1,950 — Rs. 70) = Rs. 39,48,000	2,100 × (Rs. 1,950 — Rs. 270) = Rs. 35,28,000
Case 2 (based in India 0, grant period 4 years)	2,100 × (Rs. 1,950 — Rs. 70) = Rs. 39,48,000	2,100 × (Rs. 1,950 — Rs. 270) = Rs. 35,28,000
Case 3 (based in India 10 months, grant period 48 months)	2,100 × (Rs. 1,950 — Rs. 70) = Rs. 39,48,000	2,100 × (Rs. 1,950 — Rs. 270) = Rs. 35,28,000

535.5-5P3 *Z joins B Ltd. on May 1, 2008 (salary being Rs. 1,20,000 per month). Z owns a building which is transferred by him to his employer company on December 1, 2008 for a consideration of Rs. 49,20,000. The sale*

consideration will be paid by C Ltd. which is holding company of B Ltd. Z will be allotted 2,000 shares in C Ltd. at his option at any time during January 1, 2009 and March 31, 2009 at a pre-determined price of Rs. 40 per share (market value is Rs. 2,500 per share on December 1, 2008). The Assessing Officer wants to levy FBT either on B Ltd. or C Ltd.

SOLUTION :

Allotment to shares to an employee at a concessional rate (either by the employer or by holding company of the employer) is subject to fringe benefit tax by virtue of section 115WB(1)(*d*) with effect from the assessment year 2008-09. However, section 115WB(1) is applicable only when 'fringe benefits' are provided by way of consideration for employment in the case of—

(*b*) any free or concessional ticket provided by the employer for private journeys of his employees or their family members,

(*c*) any contribution by the employer to an approved superannuation fund for employees,

(*d*) any specified security or sweat equity shares allotted or transferred, directly or indirectly free of cost or at concessional rate.

Fringe benefit tax is also applicable in the case of deemed fringe benefits specified by section 115WB(2).

Allotment of shares at discount to an employee as a consideration for transfer of a capital asset (like, house property) is not covered by sub-section (1) or sub-section (2) of section 115WB. Only shares allotted to an employee directly or indirectly by way of consideration for employment are subject to fringe benefit tax in the hands of employer under section 115WB(1)(*d*). However, capital gain on transfer of house property will be taxable in the hands of Z, as 'transfer' in section 2(*47*) covers exchange.

535.5-5P4 *X is a scientist having special knowledge in the field of bio-technology. He was in USA till 2004 before joining A Ltd. an Indian company on January 1, 2005 (salary being Rs. 2,50,000 per month). Besides, A Ltd. has given an option to X to get shares in A Ltd. (as given below) in consideration for providing technical knowledge which X has gained while working with an overseas multinational company in USA. 50 per cent of fringe benefit tax liability (if any) of the employer will be borne by X—*

Date of granting the option	January 2, 2005
Date of vesting of the option	December 31, 2005
What is the option	To purchase 1,000 shares in A Ltd. at pre-determined price of Re. 1 per share at any time during December 31, 2005 and December 31, 2009
Date of exercise of option	January 1, 2009 (to purchase 1,000 shares)
Date of allotment	January 1, 2009
Fair market value on December 31, 2005	Rs. 7,000 per share
Fair market value on January 1, 2009	Rs. 7,500 per share
Market value of the technical knowledge provided by X to A Ltd.	Rs. 58,00,000

SOLUTION :

Tax consequences in the hands of A Ltd.

In this case, fringe benefit tax will be applicable as shares are transferred to X in consideration of employment. Fringe benefit tax liability is calculated as follows—

	Rs.
Fair market value on the date of vesting (per share)	7,000
Less: Amount recovered per share from X in cash (non-monetary consideration shall be ignored)	1
Balance	6,999
Value of fringe benefits (Rs. 6,999 ×1,000) [market value of non-monetary consideration being technical knowledge cannot be deducted]	69,99,000
Fringe benefit tax (33.99% of Rs. 69,99,000)	23,78,960
Amount recovered by A Ltd. from X	11,89,480

Note - FBT recovered from the employee is not taxable. FBT paid by A Ltd. is not a deductible business expenditure.

Tax consequences in the hands of X

What is the taxable income at the time of joining or at the time of allotment of shares for providing technical knowledge	*Nil*
Cost of acquisition of one share for purpose of computing capital gain	Rs. 7,000
Can X deduct at the time of transfer of shares the consideration, being Re. 1 per share, which he has paid to get the shares in employer company	No
Can X get deduction of non-monetary consideration of Rs. 58,00,000 at the time of transfer of shares	No
Can X get deduction at the time of transfer of shares of 50% of FBT, *i.e.*, Rs. 11,89,480 paid to the employer	No

535.6 ***Computation of fringe benefits tax liability*** - Fringe benefits tax is calculated as follows —

535.6-1 ***FRINGE BENEFITS TAX RATE*** - Fringe benefits tax is calculated at the rate of 30 per cent of the value of fringe benefits.

535.6-2 ***SURCHARGE*** - Fringe benefits tax is calculated at the rate of 30 per cent will be increased by surcharge as follows —

	Surcharge at [illegible] of fringe benefit tax
If the employer is an AOP/BOI	
- if fringe benefit† does not exceed Rs. 10,00,000	*Nil*
- if fringe benefit† is above Rs. 10,00,000	10%
If the employer is an artificial juridical person	10%
If the employer is a firm	10%
If the employer is a domestic company	10%
If the employer is a non-domestic company	2.5%
If the employer is a local authority	*Nil*

535.6-3 ***EDUCATION CESS*** - It is 2 per cent of fringe benefit tax and surcharge.

535.6-4 ***SECONDARY AND HIGHER EDUCATION CESS*** - It is 1 per cent of fringe benefit tax and surcharge.

535.6-5 ***EFFECTIVE TAX RATE*** - *See* Annex 1.

535.6-6 ***WHETHER FRINGE BENEFIT TAX NEEDS TO BE SHOWN ABOVE THE LINE OR BELOW THE LINE IN THE PROFIT AND LOSS ACCOUNT*** - For the purposes of computation of total income under the Income-tax Act, fringe benefit tax is not an allowable deduction by virtue of section 40(*a*)(*ic*). However, the accounting treatment of fringe benefit tax for the purposes of reporting to shareholders and complying with the obligations under the Companies Act will be governed by the Accounting Standards issued by the Institute of Chartered Accountants of India—**Circular No. 8/2005,** dated August 29, 2005 (Question No. 17).

535.6-7 ***FRINGE BENEFIT TAX LIABILITY NOT DEDUCTIBLE*** - Fringe benefit tax liability is not a deductible business expenditure by virtue of section 40(*a*)(*ic*).

535.6-8 ***FRINGE BENEFIT TAX LIABILITY IS DEDUCTIBLE FOR COMPUTING BOOK PROFIT*** - Fringe benefit tax is a liability *qua* employer. It is an expenditure laid out or expended wholly and exclusively for the purposes of the business or profession of the employer. However, section 40(*a*)(*ic*) expressly

†It is not value of fringe benefits.

prohibits the deduction of the amount of fringe benefit tax paid, for the purposes of computing the income under the head 'Profits and gains of business or profession'. This prohibition does not apply to the computation of 'book profit' for the purposes of section 115JB. Accordingly, the fringe benefit tax is an allowable deduction in the computation of 'book profit' under section 115JB—**Circular No. 8/2005,** dated August 29, 2005 (Question No. 103).

535.6-9 *CREDIT OF FRINGE BENEFIT TAX PAID BY A FOREIGN COMPANY IN THE COUNTRY OF RESIDENCE* - The credit for fringe benefit tax paid in India may be available in the foreign country of residence on the basis of the tax laws prevailing in that foreign country and in the light of the provisions of the Double Taxation Avoidance Agreement between India and that foreign country—**Circular No. 8/2005,** dated August 29, 2005 (Question No. 28).

535.7 ***Return of fringe benefits and Form No.*** - Every employer who has paid (or made provisions for payment) fringe benefits to his employees during the previous year shall submit the return of fringe benefits to the Assessing Officer on or before the due dates given below—

Different employers	*Due date for the assessment year*
If the employer is a company	September 30
If the employer is having income from business/profession (but other than a company) and books of account are required to be audited	September 30
If the employer is having income from business/profession (but other than a company) and books of account are not required to be audited	July 31
If the employer does not have income from business/profession (but other than a company)	July 31
If the employer is not supposed to submit return of income but he or it has provided fringe benefits to his or its employees	July 31

Note: Notice can be issued by the Assessing Officer if return is not submitted.

▪ *Fringe benefit tax return Forms* - For the assessment years 2007-08 and 2008-09, the Central Board of Direct Taxes has notified the following new forms —

Form No.	*Taxpayers*	
ITR-5	Firms, AOPs and BOIs	Consolidated form for return of income and fringe benefit
ITR-6	Companies other than companies claiming exemption under section 11	Consolidated form for return of income and fringe benefit
ITR-7	Persons including companies required to furnish return under section 139(4A) or section 139(4B) or section 139(4C) or section 139(4D)	Consolidated form for return of income and fringe benefit
ITR-8	Persons not liable to submit income-tax return	Form for return of fringe benefits
ITR-V	Where the data of the Return of Income/Fringe Benefits in Form ITR-1, ITR-2, ITR-3, ITR-4, ITR-5, ITR-6 and ITR-8 transmitted electronically without digital signature.	

▪ *Belated return and revised return* - Belated return and revised return can be submitted within the following time-limit—

1. within one year from the end of the relevant assessment year; or

2. before the completion of the assessment,

whichever comes earlier.

535.8 ***Assessment*** - The provisions of summary assessment, regular assessment, reassessment, notice for reassessment are given in sections 115WE, 115WF, 115WG and 115WH. These provisions have been incorporated on similar lines as given in sections 139, 143, 144, 147 and 148.

535.9 ***Advance payment of fringe benefit tax*** - The scheme of payment of advance fringe benefit tax will be revised with effect from June 1, 2007. Advance fringe benefit tax will be payable† by a company in four instalments and by a non-corporate assessee in three instalments as follows —

	Corporate assessee	Non-corporate assessee
On or before June 15	Up to 15% of advance tax	—
On or before September 15	Up to 45% of advance tax	Up to 30% of advance tax
On or before December 15	Up to 75% of advance tax	Up to 60% of advance tax
On or before March 15	Up to 100% of advance tax	Up to 100% of advance tax

Note - Advance fringe benefit tax will have to be paid even if the quantum of such tax is less than Rs. 5,000.

In order to mitigate this hardship, the CBDT has decided that the first instalment of Fringe Benefit Tax, which was to be paid on or before June 15, 2007, and the second instalment of Fringe Benefit Tax, which is to be paid on or before September 15, 2007, in respect of transfer or allotment of specified security or sweat equity shares to its employees, may be paid on or before the December 15, 2007 (the date of third instalment) - Press release, dated September 12, 2007

Provisions Illustrated - *Computation of advance fringe benefit tax by a corporate-assessee* - X Ltd. is a paper manufacturing company. The accountant of the company estimates the following expenses for the purpose of calculating fringe benefit advance tax on June 10, 2009—

	Expenditure/depreciation Rs.	Value	Value of fringe benefits Rs.
Depreciation on car (Car 1 and Car 2, depreciated value of the block on April 1, 2009: Rs. 8,00,000)	1,20,000	20%	24,000
Cars maintenance expenses	48,000	20%	9,600
Entertainment expenditure	64,000	20%	12,800
Diwali expenditure	10,000	20%	2,000
Hotel, boarding and lodging	60,000	20%	12,000
Travelling expenditure	1,10,000	5%	5,500
Guest house maintenance	30,000	*Nil*	*Nil*
Telephone expenditure	1,72,000	20%	34,400
Expenditure on hospitality (for clients)	65,000	20%	13,000
Total			1,13,300
Fringe benefit tax @ 33.99%			38,510

Consequently, the company pays a sum of Rs. 5,800 (*i.e.*, slightly more than 15% of Rs. 38,510) on June 11, 2009.

In the first week of September 2009, the company purchases Car 3 for Rs. 15,80,000. The expected car maintenance expenses will be Rs. 84,000 (as against Rs. 48,000 estimated before the payment of first instalment of advance fringe benefit tax).

The advance fringe benefit tax (second instalment) will be determined as follows—

	Expenditure/depreciation Rs.	Value	Value of fringe benefits Rs.	Fringe benefit tax
Depreciation on car (car 1, car 2 and car 3)	3,57,000	20%	71,400	
Cars maintenance expenses	84,000	20%	16,800	
Entertainment expenditure	64,000	20%	12,800	

†After March 31, 2008, all corporate assessees and other assessees (who are subject to compulsory audit under section 44AB) will have to make electronic payment of tax through internet banking facility offered by authorized banks. Alternatively, these taxpayers can make electronic payment of tax through internet by way of credit or debit cards.

Diwali expenditure	10,000	20%	2,000	
Hotel, boarding and lodging	60,000	20%	12,000	
Travelling expenditure	1,10,000	5%	5,500	
Guest house maintenance	30,000	*Nil*	*Nil*	
Telephone expenditure	1,72,000	20%	34,400	
Expenditure on hospitality (for clients)	65,000	20%	13,000	
Total			1,67,900	
Fringe benefit tax @ 33.99%				57,070
45% of fringe benefit tax				25,682
Less: First instalment paid				5,800
Second instalment to be paid on or before September 15, 2009				19,880

The company pays Rs. 19,900 by way of second instalment of advance fringe benefit tax on September 14, 2009.

In November 2009, the company incurs the following additional expenses which were not considered for computing the first two advance fringe benefit tax instalments —

	Rs.
Conference expenses for the benefit of distributors	3,40,000
Gifts to shareholders in annual general meeting	4,30,000

Third instalment of advance fringe benefit tax will be calculated as follows -

Value of fringe benefits calculated earlier	1,67,900
Add: 20% of conference expenses	68,000
Add: 50% of gift	2,15,000
Total value of fringe benefits	4,50,900
33.99% of Rs. 4,50,900	1,53,261
75% of Rs. 1,53,261	1,14,946
Less: Advance tax is paid earlier (Rs. 5,800 + Rs. 19,900)	25,700
Third instalment payable on or before December 15, 2009	89,246

Consequently, the company pays Rs. 89,250 on account of third instalment of advance fringe benefit tax.

In the first week of March 2010, X Ltd. wants to revise the expenditure on telephone from Rs. 1,72,000 (which was estimated earlier) to Rs. 2,37,000. Computation of fourth instalment of advance fringe benefit tax will be as follows —

	Rs.
Value of fringe benefits calculated earlier	4,50,900
Add: 20% of (Rs. 2,37,000 – Rs. 1,72,000)	13,000
Total	4,63,900
Fringe benefit tax @ 33.99%	1,57,680
Less: Advance tax paid earlier (Rs. 5,800 + Rs. 19,900 + Rs. 89,250)	1,14,950
Balance	42,730

X Ltd. should pay Rs. 42,730 on or before March 15, 2010 as fourth instalment of advance fringe benefit tax.

535.10 ***Interest on shortfall or non-payment of advance tax [Sec. 115WJ]*** - For non-payment/ short payment of advance fringe benefit tax, interest will have to be paid. The mode of computation of interest as provided in section 115WJ(3)/(4)/(5) is similar (barring two exceptions given below) to the provisions regulating interest for non-payment or short payment of advance income-tax given in sections 234B and 234C.

■ In the following two cases, the scheme of levy of interest for short payment or non-payment of advance fringe benefit tax is different from the scheme of levy of interest for short payment or non-payment of advance income-tax—

1. Advance income-tax is payable in every case where the amount of such tax payable by an assessee during the financial year is Rs. 5,000 or more. In other words, if income-tax payable is lower than Rs. 5,000, there is no need to pay income-tax in advance and, consequently, for non-payment of advance income-tax in such a case, interest under sections 234B and 234C is not attracted.

In the case of fringe benefit tax, there is no such provision. Advance fringe benefit tax is payable even if such tax is lower than Rs. 5,000. To put it differently, interest under section 115WJ(3)/(4)/(5) is applicable, even if advance fringe benefit tax is lower than Rs. 5,000.

2. In the case of a corporate assessee, if advance income-tax paid up to June 15 of the previous year is not less than 12 per cent of the advance tax payable, interest under section 234C is not attracted. If, however, advance income-tax actually paid by June 15 of the previous year is lower than 12 per cent, then on the amount of short fall (*i.e.*, 15 per cent of the advance income-tax payable *minus* advance income-tax actually paid by June 15), the assessee has to pay interest under section 234C. Similarly, for short payment of second instalment of advance income-tax, a corporate assessee will not pay any interest if advance income-tax actually paid by it on or before September 15 of the previous year is not less than 36 per cent of advance tax. If income-tax actually paid by September 15 of the previous year is less than 36 per cent, then on the amount of short fall (*i.e.*, 45 per cent of the advance income-tax payable *minus* advance income-tax actually paid by September 15), the assessee has to pay interest under section 234C.

In the case of advance payment of fringe benefit tax, there is no such concession.

535.10-P1 *Y Ltd. gives the following information for the previous year 2008-09 pertaining to the assessment year 2009-10 -*

	Income-tax Rs.	Fringe benefit tax Rs.
Advance tax paid on June 10, 2008	*1,35,000*	*1,56,000*
Advance tax paid on September 12, 2008	*4,30,000*	*2,50,000*
Advance tax paid on December 9, 2008	*1,00,000*	*15,000*
Advance tax paid on March 13, 2009	*10,000*	*20,000*
Advance tax paid on March 27, 2009	*1,94,000*	*25,000*
Tax liability as per return of income and fringe benefit (income-tax liability is calculated after deducting TDS/TCS/MAT credit)	*9,70,840*	*11,15,270*
Self assessment tax paid along with return of income and fringe benefits submitted on September 30, 2009	*Nil*	*Nil*
Tax liability as per assessment order under sections 143(3) and 115WE(2) dated April 6, 2010 (income-tax liability is calculated after deducting TDS/TCS/MAT credit)	*12,36,980*	*16,10,780*

SOLUTION :

Interest for short payment of advance tax will be calculated as follows -

	Income-tax Rs.	Fringe benefit tax Rs.
Interest under sections 234B and 115WJ(5)		
Tax paid during the previous year 2008-09 (p)	8,69,000	4,66,000
Tax liability as per assessment order (q)	12,36,980	16,10,780
90% of (q)	11,13,282	14,49,702
Whether interest under section 234B or section 115WJ(5) is applicable as advance tax paid during the previous year 2008-09 is less than 90% of (q)	Yes	Yes
Short fall [(q) – (p)] (rounded off) (r)	3,67,900	11,44,700

	[redacted]	[redacted]
Interest under section 234B and section 115WJ(5) @ 1% from April 1, 2009 to April 6, 2010 [i.e., interest on (r) for 13 months @ 1% per month]	47,827	1,48,811
Interest under sections 234C and 115WJ(3)		
Tax as per return of income/fringe benefits (a)	9,70,840	11,15,270
15% of (a)	1,45,626	1,67,291
Advance tax paid up to June 15, 2008	1,35,000	1,56,000
Short fall first instalment (rounded off)	10,600	11,200
Interest on short fall [*interest under section 234C cannot be levied as advance income-tax paid is not less than 12% of (a)]	*Nil**	336
45% of (a)	4,36,878	5,01,872
Advance tax paid up to September 15, 2008	5,65,000	4,06,000
Short fall second instalment (rounded off)	*Nil*	95,800
Interest on short fall	*Nil*	2,874
75% of (a)	7,28,130	8,36,452
Advance tax paid up to December 15, 2008	6,65,000	4,21,000
Short fall third instalment (rounded off)	63,100	4,15,400
Interest on short fall	1,893	12,462
100% of (a)	9,70,840	11,15,270
Advance tax paid up to March 15, 2009	6,75,000	4,41,000
Short fall fourth instalment (rounded off)	2,95,800	6,74,200
Interest on short fall	2,958	6,742

Notes -

1. Interest under section 115WJ(3) is applicable for short payment of first instalment of advance fringe benefit tax even if advance tax paid on or before June 15, 2008 is not less than 12%.

2. Short fall in advance payment of income-tax cannot be adjusted against excess payment of advance fringe benefit tax or *vice versa* for the purpose of calculating interest under sections 234B, 234C and 115WJ.

535.11 ***Interest for default in furnishing return of fringe benefits [Sec. 115WK]*** - Section 115WK has been framed on lines similar to section 234A. It is applicable if the return of income is furnished after the due date or is not furnished. Interest is computed as follows :

1. Rate of interest	1% per month* (simple interest)
2. Period for which interest is payable	
a. if the return is furnished after the due date	Commencing on the date immediately following due date of filing the return of fringe benefits and ending on date of furnishing of return of fringe benefits
b. if no return is furnished	Commencing on the date immediately following due date of filing the return of fringe benefits and ending on date of completion of assessment under section 115WF
3. Amount on which interest is payable	
a. where interest is paid along with (or before filing) return of fringe benefits	Fringe benefits tax on value of fringe benefits as declared in the return *minus* (advance tax paid)

*Part of the month is considered as full month.

b. where interest is paid on the value of fringe benefits determined under section 115WE(1) or assessed under section 115WE(3) or 115WF or 115WG	Fringe benefit tax as determined under section 115WE(1) or on assessment under section 115WE(3) or 115WF or 115WG *minus* (advance tax paid). *See* para 535.11-1.

535.11-1 ***WHEN INTEREST IS PAID ON THE VALUE OF FRINGE BENEFITS DETERMINED UNDER SECTION 115WE(1) OR ASSESSED UNDER SECTION 115WE(3) OR 115WF AND INTEREST FOR DELAYED FILING OF RETURN IS ALREADY PAID ON OR BEFORE FILING RETURN OF FRINGE BENEFITS UNDER SECTION 115WD*** - Interest under section 115WK is computed in such cases as follows :

1. [Tax on value of fringe benefit as determined under section 115WE(1) or on assessment under section 115WE(3) or 115WG *minus* (advance tax paid)] × 1% × period for which interest under section 234A is payable.

2. [Tax on total income as declared in the return of fringe benefits *minus* (advance tax paid)] × 1% × period for which interest under section 234A is payable.

3. Compute (1) - (2). This is the amount of interest payable for delayed filing of return when income is determined under section 115WE(1) or assessed under section 115WE(3).

535.12 ***Recovery of fringe benefit tax in respect of ESOP from employees*** - A new section 115WKA has been inserted from the assessment year 2008-09 for the purpose of recovering fringe benefit tax by the employer in respect of sweat equity shares, etc. from employees. If sweat equity shares are allotted or transferred, directly or indirectly, by an employer on or after April 1, 2007, it shall be lawful for the employer to vary the agreement or scheme under which such specified security or sweat equity shares has been allotted or transferred. The agreement or scheme can be modified so as to recover from the employee the fringe benefit tax to the extent to which such employer is liable to pay the fringe benefit tax in relation to the value of fringe benefits provided to the employee and determined under the above modified provisions.

■ *Deemed payment of tax by the employee where FBT on securities allotted to him is recovered by the employer* - CBDT has issued Circular No. 9, dated December 20, 2007, clarifying that if FBT on account of share allotted or transferred under ESOPs has been paid by the employer, but recovered from an employee, it shall be deemed that the employee has paid the FBT. Therefore, such an employee can claim credit for this deemed payment of FBT in a foreign country. The same clarification has been incorporated by inserting section 115WKB. In India, however, the employee shall not be entitled for any refund out of such deemed payment of tax; and shall also not be entitled to claim any credit of such deemed payment of tax against tax liability on other income or against any other tax liability.

535.13 ***Penal provisions*** - The various penal provisions incorporated for fringe benefits tax are as follows :

535.13-1 ***CONCEALMENT OF FRINGE BENEFITS [SEC. 271]*** - Different changes which have been made in section 271 to incorporate penal provisions for fringe benefits tax are as follows :

1. Section 271(1)(*b*), presently provides for penalty of Rs. 10,000 for failure to comply with notice issued under section 142(1)/143(2) or directions issued under section 142(2A). A reference of sections 115WD(2) and 115WE(2) has been included in section 271(1)(*b*) with effect from the assessment year 2006-07.

2. The provisions for concealment penalty under section 271(1)(*c*) will also be applicable for concealing the particulars of the fringe benefits.

3. A new sub-section (6) has been inserted to clarify that any reference in section 271 to income shall be construed as references to the income or fringe benefits, as far as may be, and the provisions of section 271 shall apply in relation to any assessment in respect of fringe benefits also.

535.13-2 *PENALTY FOR DELAY IN FILING OF FRINGE BENEFITS TAX RETURN [SEC. 271FB]* - It provides that if an employer required to furnish a return of fringe benefits under section 115WD(1), fails to furnish such return within the prescribed time, Assessing Officer may direct such employer to pay, by way of penalty, a sum of Rs. 100 for every day during which the failure continues.

Section 271FB has been incorporated on lines similar to section 271F. Section 271F provides for penalty of Rs. 5,000 if return of income is not furnished before the end of relevant assessment year.

535.14 ***Prosecution*** - The following changes have been made.

535.14-1 *SECTION 276CC* - Section 276CC, *inter alia,* provides that if any person wilfully fails to furnish the return of income under section 139(1) or 148 in due time, he shall be punishable with rigorous imprisonment for a minimum term of 6 months but which may extend to 7 years in a case where the amount of tax, penalty or interest evaded exceeds Rs. 1,00,000. If, however, the tax/penalty/interest evaded is Rs. 1,00,000 or less the term of punishment may be from a period not less than 3 months to 3 years and fine.

Section 276CC has been amended with effect from assessment year 2006-07 to include references of section 115WD(1), section 115WD(2) and section 115WH.

535.14-2 *SECTION 278* - If a person abets or induces another person to make and deliver an account or statement or declaration relating to *any income or fringe benefits chargeable to tax* which is false, he is liable for punishment with rigorous imprisonment for a term not less than 6 months but which may extend to 7 years in a case where the amount of tax, penalty or interest evaded exceeds Rs. 1,00,000.

535.15 ***Overlapping between perquisite and fringe benefit*** - There is a considerable overlapping between perquisites under section 17(*2*) and fringe benefits under section 115WB(2). While dealing with these two, one has to frequently face the following questions—

1. An employee gets Rs. 1 lakh per month as salary. If no tax planning is done it will be fully taxable in the hands of the employee. The employee wants to convert some part of monthly payment of Rs. 1 lakh into a fringe benefit which is subject to fringe benefit tax (value being 20 per cent). Is it possible or is it legal tax planning ?

2. A benefit is provided to an employee or to a group of employees. It is taxable in the hands of the employees under section 15, read with section 17(*1*). The same benefit can also be taxed as employees' welfare expenditure under section 115WB(2)(*E*). Is it legal to pay fringe benefit tax on 20 per cent of the expenditure under section 115WB(*2*) instead of paying tax on full value of perquisite, as the overall tax liability will be lower ?

3. Bonus is paid to employees. It is fully taxable in the hands of employees. Is it possible to convert bonus into gift and pay fringe benefit tax on 50 per cent of the gift under section 115WB(2)(*O*) ?

4. An employee gets salary, allowances and perquisites. Although these are taxable under the head "Salaries" under section 15 in the hands of employee, he wants to convert some of these into fringe benefit to bear fringe benefit tax. As value of fringe benefits is 5 per cent/20 per cent/50 per cent of the expenditure, overall tax liability will be lower. Is it legal ?

535.15-1 *WHAT COMES FIRST* - The fact that the same benefit cannot be taxed as perquisite under section 17(*2*) and fringe benefit under section 115WB, is undisputed. A benefit, which is taxable under section 17(*2*), cannot again be taxed under section 115WB. Conversely, a fringe benefit under section 115WB cannot be doubly taxed at the same time under section 17(*2*). No one is clear on the following issues—

a. whether first one should apply the provisions of section 17(*2*) [and if it is not possible to charge tax, one can take recourse to section 115WB]; or

b. whether first one should apply the provisions of section 115WB [and if it is not possible to charge tax, one can take recourse to section 17(*2*)].

535.15-2 ***CORRECT APPROACH*** - One can follow the following steps to avoid overlapping between the provisions of taxation of salary and fringe benefits—

Step 1	*Sec. 17(2)(iv)*	*Case A6*	Find out whether the benefit extended by the employer is an obligation of the employee met by the employer. An obligation of the employee met by the employer (like loan taken by the employee is paid by the employer, tax bills of the employee are paid by the employer) is always taxable in the hands of an employee under the head "Salaries" under section 15 read with section 17(2)(iv)	It cannot be taxed under fringe benefits
Step 2	*Sec. 17(2) [not being sec. 17(2)(iv)], Rule 3 [not being rule 3(7)(ix)]*	*Cases A1 to A11 (not being A6) and B1 to B7*	Find out whether other benefits are provided which come under *Cases A1 to A11 and B1 to B7* (not being *Case A6*). These are perquisites and taxable in the hands of employees according to the provisions of rule 3	Generally, fringe benefit tax is not applicable except when the benefit is not taxable in the hands of the employee and it is covered by *Step 3*
Step 3	*Sec. 115WB (1)(b)/(c)/(d) and 115WB(2)*	-	Barring the aforesaid two steps, if any other benefit or privilege, etc. is provided under section 115WB(1)(b)/(c)/(d) or deemed to have been provided under section 115WB(2), it cannot be taxed in the hands of employees	Taxable in the hands of employer subject to the provisions discussed in earlier paras
Step 4	*Rule 3(7)(ix)*	*Case A12*	Any other benefit or amenity, service, right or privilege (not being telephone, mobile phone, anything which is covered by section 115WB) is taxable in the hands of employee	No fringe benefit tax

One has to follow these steps in the same sequence in which these are given in the table above. One cannot go to *Step 3* directly without applying *Steps 1* and *2*.

535.16 ***Case studies*** - The following case studies are given to have better understanding of fringe benefits tax.

535.16-P1 *From the profit and loss account of X Ltd. for the year ending March 31, 2009, the following data is taken—*

Rent-free house to employees	*48,70,500*	*48,70,500*
Cars (running and maintenance)	*36,50,000*	*18,10,000*
Cars (depreciation @15 per cent of WDV)	*48,10,000*	*26,15,000*
Travelling expenses	*90,00,000*	*1,000*
Tea/coffee in office	*4,81,786*	*3,50,000*

Gift		*15,20,000*	*8,10,000*
Club expenditure		*20,36,700*	*18,12,000*
Sales promotion expenditure		*90,15,400*	*Nil*
Newspaper advertisement for advertising companies products		*88,12,000*	*Nil*
Entertainment expenditure		*78,57,000*	*6,00,000*
Guest house maintenance expenditure		*60,25,000*	*15,000*
Health/sports club		*2,15,000*	*1,000*
Use of telephone		*16,07,500*	*55,000*
Scholarship		*14,30,000*	*12,00,000*
Festival celebrations		*13,87,500*	*10,000*
Hotel, boarding and lodging		*10,15,000*	*25,000*
Employees' welfare		*10,000*	*10,000*
Conference fees for employees		*12,000*	*12,000*
Conference fees for others		*18,000*	*Nil*

Find out fringe benefits tax liability for the assessment year 2009-10.

SOLUTION : *Computation of fringe benefits tax liability*

(1)	(2)	(3)	(4)
Rent-free house to employees	48,70,500	0	*Nil*
Cars (running and maintenance)	36,50,000	0.2	7,30,000
Cars (depreciation @15 per cent of WDV)	48,10,000	0.2	9,62,000
Travelling expenses	90,00,000	0.05	4,50,000
Tea/coffee in office	4,81,786	0	*Nil*
Gift	15,20,000	0.5	7,60,000
Club expenditure	20,36,700	0.5	10,18,350
Sales promotion expenditure	90,15,400	0.2	18,03,080
Newspaper advertisement for advertising companies products	88,12,000	0	*Nil*
Entertainment expenditure	78,57,000	0.2	15,71,400
Guest house maintenance expenditure	60,25,000	0	*Nil*
Health/sports club	2,15,000	0.5	1,07,500
Use of telephone	16,07,500	0.2	3,21,500
Scholarship	14,30,000	0.5	7,15,000
Festival celebrations	13,87,500	0.2	2,77,500

Major heads	Expenditure debited to profit and loss account Rs.	Value as per section 115WC	Value of fringe benefits [(2) x (3)] Rs.
(1)	(2)	(3)	(4)
Hotel, boarding and lodging	10,15,000	0.2	2,03,000
Employees' welfare	10,000	0.2	2,000
Conference fees for employees	12,000	0	*Nil*
Conference fees for others	18,000	0.2	3,600
Total			89,24,930
Fringe benefits tax @ 30% of value of fringe benefits			26,77,479
Add : Surcharge			2,67,748
Add : Education cess			58,905
Add: Secondary and higher education cess			29,452
Total fringe benefits tax liability			30,33,580

535.16-P2 *Suppose in the problem 535.16-P1, X Ltd. is engaged in the business of computer software.*

SOLUTION : *Computation of fringe benefits tax liability*

Major heads	Expenditure debited to profit and loss account Rs.	Value as per section 115WC	Value of fringe benefits [(2) x (3)] Rs.
(1)	(2)	(3)	(4)
Rent-free house to employees	48,70,500	0	*Nil*
Cars (running and maintenance)	36,50,000	0.2	7,30,000
Cars (depreciation @15 per cent of WDV)	48,10,000	0.2	9,62,000
Travelling expenses	90,00,000	0.05	4,50,000
Tea/coffee in office	4,81,786	0	*Nil*
Gift	15,20,000	0.5	7,60,000
Club expenditure	20,36,700	0.5	10,18,350
Sales promotion expenditure	90,15,400	0.2	18,03,080
Newspaper advertisement for advertising companies products	88,12,000	0	*Nil*
Entertainment expenditure	78,57,000	0.2	15,71,400
Guest house maintenance expenditure	60,25,000	0	-
Health/sports club	2,15,000	0.5	1,07,500
Use of telephone	16,07,500	0.2	3,21,500
Scholarship	14,30,000	0.5	7,15,000
Festival celebrations	13,87,500	0.2	2,77,500
Hotel, boarding and lodging	10,15,000	0.05	50,750
Employees' welfare	10,000	0.2	2,000
Conference fees for employees	12,000	0	*Nil*
Conference fees for others	18,000	0.2	3,600
Total			87,72,680

Major heads	Expenditure debited to profit and loss account Rs.	Value as per section 115WC	Value of fringe benefits (2) × (3) Rs.
(1)	(2)	(3)	(4)
Fringe benefits tax @ 30% of value of fringe benefits			26,31,804
Add: Surcharge			2,63,180
Add: Education cess			57,900
Add: Secondary and higher education cess			28,950
Total fringe benefits tax liability			29,81,830

535.16-P3 *X Ltd. manufactures tea in India. 40 per cent of the income is taken as non-agricultural income. It has a few branch offices in Sri Lanka, UK, USA and Russia. The company does not maintain separate books of account for branch offices. The company incurs an expenditure on entertainment, hospitality, sales promotion, tour and travel, car, club facility, employees' welfare and telephone. The company has 297 employees during the previous year 2008-09 out of which 57 are posted in overseas branches. The breakup is given below—*

	Employees in India	Employees in foreign branches
Clerks and peons	*50*	*6*
Other employees	*190*	*51*
Salary and allowances to clerks and peons	*Rs. 63,00,850*	*Rs. 34,56,000*
Salary and allowances to other employees	*Rs. 4,10,40,500*	*Rs. 4,59,15,240*

During the year ending March 31, 2009, the company has incurred the following expenditure—

	Rs.
Entertainment	*8,20,000*
Hospitality	*12,15,000*
Sales promotion	*38,52,000*
Tour and travel	*74,48,000*
Car	*22,25,000*
Club facility	*7,15,000*
Employees' welfare	*3,54,000*
Telephone	*8,37,500*

Other points—

1. Entertainment expenditure does not include an expenditure of Rs. 80,000 for purchase of music system for the benefit of employee.

2. Expenditure on hospitality includes Rs. 3,10,000 being expenditure on providing food and beverages to its employees posted in Delhi and Bangalore. It further includes an expenditure of Rs. 2,75,000 on purchase of lunch vouchers which are given to its employees posted in UK.

3. Sales promotion includes Rs. 72,000 being expenditure of free samples of tea given in UK and USA.

4. Sales promotion also includes an expenditure of Rs. 12,10,000 for shooting an ad-film for promoting company's sale in overseas market.

5. Tour and travel expenses are only for official purposes.

6. Car expenses are only for official purposes. Whenever these cars are used by employees for personal purposes, an amount at the rate of Rs.10 per kilometre is recovered from employees. The amount so recovered is transferred to staff welfare fund. During the previous year the quantum of such recovery will be Rs. 84,000. This amount will be shown in the balance sheet. However, nothing is recovered from overseas employees. Besides, car expenses given above the company will claim depreciation on cars (approximate depreciation for the entire year for income-tax purposes will be Rs. 32,50,000, whereas depreciation for accounting purposes will be Rs. 23,00,400). The company will pay interest on loan taken to purchase cars (amount of interest being Rs. 8,18,000 which will appear as "interest" in profit and loss account for the year ending March 31, 2009).

7. Club facility expenditure does not include depreciation of club building. Club facility is enjoyed entirely by official guest of the company at different locations.

8. Employees welfare does not include contribution by X Ltd. towards recognized provident fund.

9. Employees welfare expenditure includes Rs. 70,000 on prizes and awards given to employees on the basis of performance. It also includes Rs. 89,000 for providing subsidized transport journeys to employees between office and residence.

10. Telephone expenditure is fully for official purposes.

Find out fringe benefit tax liability of the company for the assessment year 2009-10.

SOLUTION :

[illegible]	[illegible]	Value of Fringe Benefit Rs.	[illegible]
Entertainment expenditure	8,20,000	1,64,000	Music system for employees is eligible for depreciation under section 32. Depreciation is included for the purpose of calculating fringe benefit tax only in the case of cars and aircrafts. Depreciation is not included for other purposes in the absence of any specific charge—***Circular No. 8/2005,*** dated August 29, 2005 (Question No. 91).
Hospitality (Rs. 12,15,000 – Rs. 3,10,000 – Rs. 2,75,000)	6,30,000	1,26,000	Expenditure on providing food and beverages is not included. Likewise, expenditure on purchase of lunch vouchers has been excluded on the exemption that these vouchers are not transferable and can be used by employees at eating joints.
Sales promotion (Rs. 38,52,000 – Rs. 72,000 – Rs. 12,10,000)	25,70,000	5,14,000	Expenditure on free samples is not subject to fringe benefit tax. Expenditure on making an ad-film is not subject to fringe benefit tax - ***Circular No. 8/2005,*** dated August 29, 2005 (Question No. 65).
Tour and travel	74,48,000	3,72,400	Even if the expenditure is for official purposes, it is subject to fringe benefit tax.
Car (Rs. 22,25,000 + Rs. 32,50,000 + Rs. 8,18,000 – Rs. 84,000)	62,09,000	12,41,800	Depreciation of motor car is subject to fringe benefit tax—***Circular No. 8/2005,*** dated August 29, 2005 (Question No. 83). Likewise interest on loan taken to purchase motor car is subject to fringe benefit tax—***Circular No. 8/2005,*** dated August 29, 2005 (Question No. 84). In case of recovery, only net expenditure is subject to fringe benefit tax—***Circular No. 8/2005***, dated August 29, 2005 (Question No. 32).

Expenditure	Expenditure (Rs.)	Value of fringe benefit (Rs.)	Remarks
Club facility	7,15,000	3,57,500	Depreciation of club building is not subject to fringe benefit tax. Depreciation is included for the purpose of calculating fringe benefit tax only in the case of cars and aircrafts. Depreciation is not included for other purposes in the absence of any specific charge—***Circular No. 8/2005,*** dated August 29, 2005 (Question No. 91).
Employees' welfare (Rs. 3,54,000 – Rs. 89,000)	2,65,000	53,000	Employer's contribution towards recognized provident fund is not subject to fringe benefit tax —***Circular No. 8/2005,*** dated August 29, 2005 (Question No. 38). Expenditure on subsidized transport to employees between office and residence is not subject to fringe benefit tax—***Circular No. 8/2005,*** dated August 29, 2005 (Question No. 104). Expenditure on prizes and awards is subject to fringe benefit tax—***Circular No. 8/2005,*** dated August 29, 2005 (Question No. 76).
Telephone	8,37,500	1,67,500	It is subject to fringe benefit tax even if the entire expenditure is for official purposes. Expenses need not be segregated into those incurred for official purposes and those for personal purposes—***Circular No. 8/2005,*** dated August 29, 2005 (Question No. 15).
Total		29,96,200	

	Rs.
Value of fringe benefit (a)	29,96,200
Value of fringe benefit pertaining to employee based in India [(a) × 240 ÷ 297]—***Circular No. 8/2005,*** dated August 29, 2006 (Question No. 20)	24,21,172
Fringe benefit tax @ 30%	7,26,352
Add: Surcharge @ 10%	72,635
Total	7,98,987
Add: Education cess	15,980
Add: Secondary and higher education cess	7,990
Fringe benefit tax liability	8,22,960

BANKING CASH TRANSACTION TAX

Banking cash transaction tax

536. The provisions regarding banking cash transaction tax are given below—

536.1 ***Basic concepts*** - It is applicable to the whole of India except the State of Jammu and Kashmir. It is applicable from June 1, 2005 to March 31, 2009*. The term "person" has been defined to have the same meaning as assigned in section 2(*31*) of the Income-tax Act and also includes an office or establishment of the Central Government or the Government of a State.

***Banking cash transaction tax shall not be charged in respect of any taxable banking transaction after March 31, 2009.**

536.2 ***Taxable banking transaction*** - Taxable banking transaction means the following—

1. Cash withdrawal - Withdrawal of cash (by whatever mode) on any single day from an account (other than savings bank account) maintained with any scheduled bank exceeding the following amount—

Account (not being savings bank account) maintained by—	*Amount of withdrawal—*
Any individual or Hindu undivided family	Rs. 50,000 (Rs. 25,000 upto May 31, 2007)
A person other than any individual or Hindu undivided family	Rs. 1,00,000

2. Encashment of term deposit - Receipt of cash from any scheduled bank on any single day on encashment of one or more term deposits (whether on maturity or otherwise) exceeding the following amount—

Term deposit in the name of—	*Amount of withdrawal—*
Any individual or Hindu undivided family	Rs. 50,000 (Rs. 25,000 up to May 31, 2007)
A person other than any individual or Hindu undivided family	Rs. 1,00,000

536.2-1 ***OTHER POINTS*** - One should also keep in view the following points—

▪ *Exemption limit* - Transactions of withdrawal of cash from a bank account or receipt of cash on encashment of term deposit or deposits (with a scheduled bank) on any single day not exceeding Rs. 50,000 in the case of individuals and HUFs and Rs. 1,00,000 in the case of any other person, are exempt from levy of this tax. However, in respect of transactions in excess of these limits, no benefit is available in respect of the exemption limit.

For example, in respect of a transaction of withdrawal of cash of Rs. 1,45,000 on October 1, 2007 from a current account maintained by X Ltd. with SBI, Chandni Chowk, banking cash transaction tax is leviable on the amount of Rs. 1,45,000 and not on the excess of Rs. 45,000 over the exemption limit of Rs. 1,00,000.

▪ *Multiple transactions* - The value of the taxable banking transaction shall be the amount of cash withdrawal or the amount of cash received on encashment of a term deposit or deposits, as the case may be, on any single day. For this purpose, multiple withdrawals of cash from the same account (or multiple receipts of cash on encashment of a term deposit or deposits) in the name of the same person on any single day shall be treated as a single taxable banking transaction.

The following points should be noted—

1. Where the cash withdrawals are from different branches of a bank on a single day, such withdrawals will not be aggregated for the purposes of levy of banking cash transaction tax.

2. Cash receipts on encashment of term deposits with different branches of a bank on a single day will also not be aggregated for the purposes of this levy.

3. Transactions of cash withdrawal and cash receipts on encashment of term deposits on a single day will also not be aggregated for the purposes of this levy.

Provisions illustrated - The following illustrations are given—

1. Ram Lal Sharma, an individual and a sole proprietor of a trading business, has a current account entitled "Ram Lal Sharma" with Allahabad Bank, Andheri Branch, Bombay. On July 10, 2008 he withdraws Rs. 80,000 from this account as follows—

Rs. 20,000 at 10:00 AM

Rs. 30,000 at 11:00 AM

Rs. 30,000 at 12:30 PM

As the total withdrawal from the above account on a single day exceeds Rs. 50,000, Ram Lal Sharma will be liable to banking cash transaction tax on the aggregate cash withdrawal of Rs. 80,000.

2. Suppose in the above case, Ram Lal Sharma has two different current accounts – one with Allahabad Bank, Andheri Branch and the other with Allahabad Bank, Nariman Point Branch, Bombay. On July 12, 2008, he withdraws

Rs. 45,000 from Andheri Branch and Rs. 65,000 from Nariman Point Branch. The banking cash transaction will be applicable only in respect of withdrawal of Rs. 65,000 from Nariman Point Branch. Withdrawal of Rs. 45,000 from the Andheri Branch will not be subject to banking cash transaction tax.

3. S.L. Verma is a sole proprietor of a manufacturing unit. He has two current accounts with Citibank, T. Nagar, Chennai – the first in the name of S.L. Verma (current account No. 211) and second in the name of Verma Associates (current account No. 398). The two accounts are operated by him for his sole proprietorship concern. On September 1, 2008, he withdraws Rs. 35,000 from Account No. 211 and Rs. 40,000 from Account No. 398. As S.L. Verma maintains two accounts in the same bank and withdraws up to Rs. 50,000 from each account in a single day, he would not be liable to the banking cash transaction tax.

▪ *Withdrawal by credit card* - If cash is withdrawn by using a credit card, such withdrawals will not be subject to banking cash transaction tax. However, if cash is withdrawn by using a debit card, such withdrawals from any account other than a savings bank account will be liable to banking cash transaction tax.

536.3 *Charge of banking transaction tax* - Every taxable banking transaction entered into on or after June 1, 2005 shall be chargeable to banking cash transaction tax. Tax will be calculated @ 0.1 per cent (no surcharge, no education cess) of the value of every such taxable banking transaction (given in column 3 of the table *infra*). It shall be payable by the person given in column 2 of the table *infra*—

Transactions	*Who is liable*	*Value*
Withdrawal of cash from an account other than savings account	The person from whose account cash is withdrawn	The amount of cash withdrawn
Encashment of term deposit	The person who receives cash on encashment	The amount of cash received on encashment of term deposit(s)

Note - No banking cash transaction tax shall be payable if the amount of term deposit is credited to any account with the bank.

536.4 *Collection and recovery* - Every scheduled bank shall collect the banking cash transaction tax at the specified rate, from every person entering into a taxable banking transaction with that bank. The banking cash transaction tax so collected during any calendar month shall be paid by every scheduled bank to the credit of the Central Government by the 15th day of the month immediately following the said calendar month. Any scheduled bank that fails to collect the tax shall be liable to pay the tax to the credit of the Central Government out of its own pocket.

536.5 *Return* - Every scheduled bank shall within the prescribed time after the end of each financial year, furnish a return to the Assessing Officer (or any other authority or agency authorised by the Board), in prescribed form, in respect of all taxable securities transactions entered into during any financial year.

The Assessing Officer may issue a notice to any assessee who is responsible for collection of banking cash transaction tax and has not furnished the return within the prescribed time, asking the assessee to furnish the return within the time specified in the notice. A revised/belated return can be submitted before the assessment is made in cases where the assessee has not furnished a return within the time allowed or on discovery of any omission or wrong statement in the return furnished earlier.

536.6 *Assessment* - Power has been conferred on the Assessing Officer to make an assessment of the taxable banking transaction and determine the banking cash transaction tax payable or refundable on the basis of such assessment.

▪ No assessment shall be made after the expiry of 2 years from the end of the relevant financial year (it is not assessment year). For instance, for the financial year 2007-08, the assessment should be completed on or before March 31, 2010. In cases where any refund has been issued to a bank, the bank shall refund the same to the person from whom it was collected within the prescribed time.

536.7 ***Rectification of mistake*** - The Assessing Officer may amend any order passed by him with a view to rectifying any mistake apparent from record.

- Such rectification can be made within 1 year from the end of the financial year in which the order sought to be amended was passed. For instance, if the order pertaining to the financial year 2007-08 is passed on January 10, 2010, it can be rectified at any time on or before March 31, 2011.
- Any amendment which has the effect of enhancing an assessment or reducing a refund or otherwise increasing the liability of the assessee, shall be made only after giving the assessee a reasonable opportunity of being heard.

536.8 ***Interest on delayed payment of tax*** - Every assessee who fails to credit the banking cash transaction tax to the account of the Central Government within the specified period shall pay simple interest at the rate of 1 per cent of such tax for every month (or part of a month) by which crediting of the tax has been delayed.

536.9 ***Penalty*** - The provisions regulating penalty are as follows—

Failure to collect tax	In addition to paying tax and interest, the assessee will be liable for a penalty, a sum equal to 100 per cent of banking cash transaction tax which it has failed to collect
Failure to pay tax after collecting it	In addition to paying tax and interest, the assessee will be liable for a penalty, a sum of Rs. 1,000 for every day during which default continues (maximum penalty cannot exceed 100 per cent of banking cash transaction tax which it has failed to pay)
Failure to furnish prescribed return	A sum of Rs. 100 for every day during which the failure continues
Failure to comply with notice	A sum of Rs. 10,000 for every such failure (it is in addition to tax and interest)

Note - No penalty will be imposable if the assessee proves that there was reasonable cause for the failure to comply with the provisions. No order imposing a penalty shall be made unless the assessee has been given a reasonable opportunity of being heard.

536.10 ***Application of certain provisions of the Income-tax Act*** - Sections 120, 131, 133A, 156, 178, 220 to 227, 229, 232, 260A, 261, 262, 265 to 269, 278B, 282 and 288 to 293 of the Income-tax Act, shall apply in relation to banking cash transaction tax.

536.11 ***Appeal to CIT (Appeal)*** - Where the assessee is aggrieved by any assessment order passed by the Assessing Officer, he may file an appeal to the Commissioner of Income-tax (Appeals).

- The appeal should be filed in prescribed form.
- The appeal should be filed within 30 days from the date of receipt of the order of the Assessing Officer.
- The provisions of sections 249 to 251 of the Income-tax Act shall, as far as may be, apply.

536.12 ***Appeal to Tribunal*** - The bank may appeal to the Appellate Tribunal against the order of the CIT (Appeals). Where the Commissioner of Income-tax objects to any order passed by the Commissioner of Income-tax (Appeals), he may direct the Assessing Officer to file an appeal to the Appellate Tribunal against such order.

- Such appeal should be filed within a period of 60 days from the date on which the order sought to be appealed against is received by the assessee or by the Commissioner.
- Such appeal should be in prescribed form.
- Appeal filed by the bank should accompany a fee of Rs. 1,000.
- The provisions of sections 252 to 255 of the Income-tax Act shall, as far as may be, apply.