PAPER – 5: ADVANCED MANAGEMENT ACCOUNTING

QUESTIONS

Total Quality Management

1. KNM Road Carriers is a transporting company that transports goods from one place to another. It measures quality of service in terms of:

   (i) Time required to transport goods

   (ii) On–time delivery

   (iii) Number of lost or damaged cartons.

   To improve its business prospects and performance the company is seriously considering to install a scheduling and tracking system, which involves an annual outlay of ₹1,25,000. The company furnishes the following information about its present and anticipated future performance:

	Current	Expected
On–time delivery	85%	95%
Variable costs per carton lost ordamaged	₹ 55	₹ 55
Fixed costs per carton lost or damaged	₹ 45	₹ 45
Number of cartons lost or damaged	2,500	1,200

   The company expects that each half per cent point increase in on–time performance will result in revenue increase of ₹9,000 per annum. Contribution margin of 45% is required.

   Required

   (i) Should KNM Road Carriers acquire and install the new system?

   (ii) Also calculate additional amount of revenue required if benefits from new system is equal to cost & Contribution margin is 47.5%.

Kaizen Costing System

2. FZ India Ltd. (FZIL) is an automobile manufacturer in India and a subsidiary of Japanese automobile and motorcycle manufacturer Fuji. It manufactures and sells a complete range of cars from the entry level to the hatchback to sedans and has a present market share of 27% of the Indian passenger car markets. FZIL uses a system of standard costing to set its budgets. Budgets are set semi-annually by the Finance department after the approval of the Board of Directors at FZIL. The Finance department prepares variance reports each month for review in the Board of Directors meeting, where actual performance is compared with the budgeted figures. Ms. Kiyoshi, group CEO of the Fuji is of the opinion that Kaizen costing method should be implemented as a system of planning and control in the FZIL.

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Required

Recommend key changes vital to FZIL's planning and control system to support the adoption of Kaizen Costing Concepts.

Activity Based Costing

3. A manufacturing company produces Ball Pens that are printed with the logos of various companies. Each Pen is priced at ₹5. Costs are as follows:

Cost Driver	Unit Variable Cost (₹)	Level of Cost Driver
Units Sold	2.5	-
Setups	225	40
Engineering hours	10	250

Other Data

Total Fixed Costs (conventional) ₹ 48,000

Total Fixed Costs (ABC) ₹ 36,500

Required

(i) Compute the break-even point in units using activity-based analysis.

(ii) Suppose that company could reduce the setup cost by ₹ 75 per setup and could reduce the number of engineering hours needed to 215. How many units must be sold to break even in this case?

Just in Time

4. Haigh Ltd. is a leading manufacturing company. Under increasing pressure to reduce costs, to contain inventory and to improve service, Haigh's Costing Department has recently undertaken a decision to *implement a JIT System*.

The management of Haigh is convinced of the benefits of their changes. But Supplies Manager Mr. Smith fears with the Costing Department's decision. He said:

"We've been driven by suppliers for years ... they would insist that we could only purchase in thousands, that we would have to wait weeks, or that they would only deliver on Mondays!"

Required

Is Mr. Smith's view point correct and why?

Limiting Factor

5. List out the basis for deciding the priority of selecting the best product in the different circumstances stated below:

(i) When maximum sales (in value) is a limiting factor.

(ii) When raw-material is a limiting factor.

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(iii) When labour hour is a limiting factor.

(iv) When there is a heavy demand for the product.

Break-even Point (Batches)

6. DRB Ltd. is a leading Home Appliances manufacturer. The company uses just-in- time manufacturing process, thereby having no inventory. Manufacturing is done in batch size of 100 units which cannot be altered without significant cost implications. Although the products are manufactured in batches of 100 units, they are sold as single units at the market price. Due to fierce competition in the market, the company is forced to follow market price of each product. The following table provides the financial results of its four unique products:

	D_1	D_2	D_3	D_4	Total
Sales (units)	2,00,000	2,60,000	1,60,000	3,00,000	
	(₹)	(₹)	(₹)	(₹)	(₹)
Revenue	26,00,000	45,20,000	42,40,000	32,00,000	145,60,000
Less: Material Cost	6,00,000	18,20,000	18,80,000	10,00,000	53,00,000
*Less:*Labour Cost	8,00,000	20,80,000	12,80,000	12,00,000	53,60,000
Less: Overheads	8,00,000	7,80,000	3,20,000	12,00,000	31,00,000
Profit / (Loss)	4,00,000	(1,60,000)	7,60,000	(2,00,000)	8,00,000

Since, company is concerned about loss in manufacturing and selling of two products so, it has approached you to clear picture on its products and costs. You have conducted a detailed investigation whose findings are below:

The overhead absorption rate of ₹2 per machine hour has been used to allocate overheads into the above product costs. Further analysis of the overhead cost shows that some of it is caused by the number of machine hours used, some is caused by the number of batches produced and some are product specific fixed overheads that would be avoided if the product were discontinued. Other general fixed overhead costs would be avoided only by the closure of the factory. Numeric details are summarized below:

	₹	₹
Machine hour related		6,20,000
Batch related	.	4,60,000
Product specific fixed overhead:		
D_1	10,00,000	
D_2	1,00,000	
D_3	2,00,000	
D_4	1,00,000	14,00,000
General fixed overheads		.6,20,000
		31,00,000

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The other information is as follows:-

	D_1	D_2	D_3	D_4	Total
Machine Hours	4,00,000	3,90,000	1,60,000	6,00,000	15,50,000
Labour Hours	1,00,000	2,60,000	1,60,000	1,50,000	6,70,000

Required

(i) Prepare a profitability statement that is more useful for decision making than the profit statement prepared by DRB Ltd.

(ii) Calculate the break-even volume in batches and also in approximate units for Product 'D_1'.

Flexible Budget

7. WDG Ltd. Had prepared fixed and flexible budget for the financial year 2015-16 as under:

	Fixed Budget *for full capacity* (₹)	Flexible Budget *for 75% level* (₹)
Sales	13,50,000	10,12,500
Direct Material	4,25,000	3,18,750
Direct Labour	1,85,000	1,38,750
Variable Overheads	2,15,000	1,61,250
Semi-Variable Overheads	3,65,000	3,23,750
Profit	1,60,000	70,000

After the closing of the financial year 2015-16, total actual sales stood at ₹11,07,000 and there was a favourable sales price variance of ₹17,000 (F).

Required

Prepare a flexible budget for the actual level of sales.

Pareto Analysis

8. Nine Plus Technology Ltd. develops cutting-edge innovations that are powering the next revolution in mobility and has nine tablet smart phone models currently in the market whose previous year financial data is given below:

Model	Sales (₹'000)	Profit-Volume (PV) Ratio
Tab - A001	5,100	3.53%
Tab - B002	3,000	23.00%
Tab - C003	2,100	14.29%
Tab - D004	1,800	14.17%
Tab - E005	1,050	41.43%

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Tab - F006	750	26.00%
Tab - G007	450	26.67%
Tab - H008	225	6.67%
Tab - I009	75	60.00%

Required

Using the financial data, carry out a Pareto analysis (80/20 rule) ofSales andContribution. Discuss your findings with appropriate recommendations.

Standard Costing

9. Sapporo Manufacturing Co. (SMC) is a leading consumer goods company. The budgeted and actual data of SMC for the year 2014-15 are as follows:-

Particulars	Budget	Actual	Variance
Sales / Production (units)	2,00,000	1,65,000	(35,000)
Sales (₹)	21,00,000	16,92,900	(4,07,100)
Less: Variable Costs (₹)	12,66,000	10,74,150	1,91,850
Less: Fixed Costs (₹)	3,15,000	3,30,000	(15,000)
Profit	5,19,000	2,88,750	(2,30,250)

The budgeted data shown in the table is based on the assumption that total market size would be 4,00,000 units but it turned out to be 3,75,000 units.

Required

Prepare a statement showing reconciliation of budget profit to actual profit through marginal costing approach for the year 2014-15 in as much detail as possible.

Decision Making

10. South Roadways Services Pvt. Ltd. is planning to run a fleet of 15 buses in Chittoor District on a fixed route. Company has estimated a total of 2,51,85,000 passenger kilometers per annum. It is estimated buses to have 100% load factor. Buses are purchased at a price of ₹ 44,00,000 per unit whose scrape value at the end of 5 years life is ₹ 5,50,000. Seating capacity of a bus excluding a Driver's seat is 42. Each bus can give a mileage of 5 kmpl. Average cost of fuel is ₹ 66 per liter. Cost of Lubricants & Sundries per 1,000 km would be ₹ 3,300. Company will pay ₹ 27,500 per month to Driver and two attendants for each bus.

Other annual charges per bus: Insurance ₹ 55,000, Garage Charges ₹ 33,000, Repairs & Maintenance ₹ 55,000. Route Permit Charges upto 20,000 km is ₹ 5,500 and ₹ 2,200 for every additional 5,000 km or part thereof.

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Required

(i) Calculate a suggested fare per passenger/km taking into account markup on cost @ 20% to cover general overheads and sufficient profit.

(ii) The Transport Sector of Chittoor is highly regulated. The Government has fixed the fare @ ₹ 1.35 for next 2 years. Comment on the two year's profitability taking into consideration the inflation rate of 8%.

Note: Route permit charges is not subject to Inflation.

Transfer Pricing

11. AWB Ltd. has two divisions Division W and Division B. Division W produces product Z, which it sells to external market and also to Division B. Divisions in the AWB Ltd. are treated as profit centres and divisions are given autonomy to set transfer prices and to choose their supplier. Performance of each division measured on the basis of target profit given for each period.

Division W can produce 1,00,000 units of product Z at full capacity. Demand for product Z in the external market is for 70,000 units only at selling price of ₹ 2,500 per unit. To produce product Z Division W incurs ₹ 1,600 as variable cost per unit and total fixed overhead of ₹ 4,00,00,000. Division W has employed ₹ 12,00,00,000 as working capital, working capital is financed by cash credit facility provided by its lender bank @ 11.50% p.a. Division W has been given a profit target of ₹ 2,50,00,000 for the year.

Division B has found two other suppliers C Ltd and H Ltd. who are agreed to supply product Z.

Division B has requested a quotation for 40,000 units of product Z from Division W.

Required

(i) Calculate the transfer price per unit of product Z that Division W should quote in order to meet target profit for the year.

(ii) Calculate the two prices Division W would have to quote to Division B, if it became AWB Ltd. policy to quote transfer prices based on opportunity costs.

Linear Programming

12. The manufacturing company has 100 kg of A, 180 kg of B and 120 kg of C ingredients available per month. Company can use these materials to make three basic products namely 5-10-5, 5-5-10 and 20-5-10, where the numbers in each case represent the percentage of weight of A, B and C respectively in each of products. The cost of these raw materials are as follows:

Ingredient	Cost per Kg. (₹)
A	64
B	16
C	40
Inert Ingredients	16

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Selling price of these products are ₹ 32.60, ₹ 34.80, and ₹ 36.00 per Kg, respectively. There is capacity restriction of the company product 5-10-5, so that company cannot produce more than 30 Kg per month.

Required

Formulate this problem as an LP model to determine the productions (in Kg.) of each product which will maximise its monthly profit.

Note: Formulate Only

Transportation Problem

13. Coupers Partners a leading CA firm has three managers. Each manager can work up to 176 hours during the next month, during which time three assignments must be completed. Tax Accounting (TA) Assignment will take 143 hours, Tax Performance Advisory (TPA) will take 154 hours, and Global Compliance & Reporting (GCR) will take 176 hours. The amount per hour that can be billed for assigning each manager to each assignment is given below:

Manager	Assignment		
	TA (₹)	TPA (₹)	GCR (₹)
C_1	1,800	2,250	2,850
C_2	2,100	1,950	1,800
C_3	2,400	2,100	2,250

Required

Formulate this as a transportation problem and find the optimal solution. Also find out the maximum total billings during the next month.

Note: A manager may be involved in more than one assignment.

PERT and CPM

14. State the Validity of following statements along with the reasons:

(i) Two activities have common predecessor and successor activities. So, they can have common initial and final nodes.

(ii) In respect of any activity whether real or dummy, the terminal node should bear a number higher than the initial node number.

(iii) The difference between the latest event time and the earliest event time is termed as free float.

(iv) For every critical activity in a network, the earliest start and the earliest finish time as well as the latest finish time and the latest start time are the same.

(v) The optimal duration of a project is the minimum time in which it can be completed.

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(vi) Resource leveling aims at smoothening of the resource usage rate without changing the project duration.

Simulation

15. Finance Controller of Dunk Limited has drawn the following projections with probability distribution:

Raw Material		Wages & Other Variable Overheads		Sales	
₹ in 000	Probability	₹ in 000	Probability	₹ in 000	Probability
08 – 10	0.2	11 – 13	0.3	34 – 38	0.1
10 – 12	0.3	13 – 15	0.5	38 – 42	0.3
12 – 14	0.3	15 – 17	0.2	42 – 46	0.4
14 – 16	0.2			46 – 50	0.2

Opening cash balance is ₹ 40,000 and fixed cost is estimated at ₹ 15,000 per month.

Required

Simulate cash flow projection and expected cash balance at the end of the sixth month. Use the following single digit random numbers.

Raw Material	4 3 1 0 4 6
Wages & Other Variable Overheads	2 7 9 1 8 9
Sales	0 6 6 0 2 8

Learning Curve

16. Marketing manager of AV Ltd. has conducted a market research on the price-demand relationship for its consumer durable product 'K-2'. K-2 is a recently launched product. The price-demand pattern will be as follows:

Price per unit (₹)	Demand (units)
11,100	1,000
10,700	2,000
9,600	3,000
8,700	4,000

K-2 is produced in batches of 1,000 units. Production manager of AV Ltd. has also researched and studied the production pattern and has believe that 50% of the variable manufacturing cost would have learning and experience curve effect. This learning & experience curve effect will be continued upto 4,000 units of production at a constant rate. But after 4,000 units of production, unit variable manufacturing cost would be equal to the unit cost at the 4th batch. The manufacturing unit cost of the first batch will be

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₹ 4,400 of which only 50% is subjected to learning and experience curve effect. The average unit variable cost of all 4 batches will be ₹4,120.

Required

(i) Calculate the rate of learning that has been expected by the Production manager.

(ii) Calculate the price at which AV Ltd. should sell the K-2 in order to maximise its contribution.

Note

log0.93 = -0.0315, log2 = 0.3010, $2^{-0.1047}$ = 0.9299, $3^{-0.1047}$ = 0.8913, $4^{-0.1047}$ = 0.8649

SUGGESTED ANSWERS/ HINTS

1. **(i) Should KNM Road Carriers acquire and install the new system?**

	₹
Additional Costs of the new scheduling & tracking system p.a.	1,25,000
Additional Revenue from improvement in on-time performance (₹ 9,000 × 10%/0.5%)	1,80,000
Contribution from Additional Annual Revenue (45% × ₹ 1,80,000) (A)	81,000
Cost Saving in respect of Cartons [(2,500-1,200) ×₹ 55] …(B)	71,500
Total Benefits …(A+B)	1,52,500

As Expected Benefits are more than the cost. Accordingly company should install the new system.

Calculation of additional amount of revenue required if benefits from new system is equal to cost & Contribution margin is 47.5%:

	₹
Costs of the new scheduling & tracking system …(A)	1,25,000
Cost Saving in respect of Cartons …(B)	71,500
Contribution Margin …(A – B)	53,500
Contribution Margin%	47.5
Corresponding Additional Revenue	1,12,632

2. **Kaizen Costing** emphasizes on *small but continuous improvement*. Targets once set at the beginning of the year or activities are *updated continuously* to reflect the improvement that has already been achieved and that are yet to be achieved.

The suggestive changes which are required to be adopted Kaizen Costing concepts in FZIL are as follows:

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Standard Cost Control System to Cost Reduction System: Traditionally Standard Costing system assumes stability in the current manufacturing process and standards are set keeping the normal manufacturing process into account thus the whole effort is on to meet performance cost standard. On the other hand Kaizen Costing believes in continuous improvements in manufacturing processes and hence, the goal is to achieve cost reduction target. The first change required is the standard setting methodology i.e. from earlier Cost Control System to Cost Reduction System.

Reduction in the periodicity of setting Standards and Variance Analysis: Under the existing planning and control system followed by the FZIL, standards are set semi-annually and based on these standards monthly variance reports are generated for analysis. But under Kaizen Costing system cost reduction targets are set for small periods say for a week or a month. So the period covered under a standard should be reduced from semi-annually to monthly and the current practice of generating variance reports may be continued or may be reduced to a week.

Participation of Executives or Workers in standard setting: Under the Kaizen Costing system participation of workers or executives who are actually involved in the manufacturing process are highly appreciated while setting standards. So the current system of setting budgets and standards by the Finance department with the mere consent of Board of Directors required to be changed.

3. **Break Even Units**

1. [Fixed Costs + (Setup Cost ×Setups) + (Engineering Cost ×Engineering Hours)]/ (Sale Price − Variable Cost)

   = [36,500 + (₹ 225 × 40) + (₹10 × 250)] / (₹ 5 – ₹ 2.5)

   = 19,200 units

2. [Fixed Costs + (Setup Cost ×Setups) + (Engineering Cost ×Engineering Hours)]/ (Sale Price − Variable Cost)

   = [36,500 + (₹150 × 40) + (₹10 × 215)] / (₹ 5 – ₹ 2.5)

   = 17,860 Units

4. **JIT Inventory System**

"For successful operation of JIT inventory system, the suppliers chosen must be willing to make frequent deliveries in small lots. Rather than deliver a week's or a month's material at one time, suppliers must be willing to make deliveries several times a day and in the exact quantities specified by the buyer."

It is described in the problem that suppliers are not willing to

- make frequent deliveries and
- make supplies in the exact quantities as required

Accordingly, Mr. Smith's doubt is correct on successful implementation of JIT System.

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5. **Limiting Factor**

Case	Basis for Selecting Priority of Product
If maximum sales (in value) is a limiting factor	Profit Volume Ratio
If raw material is a limiting factor	Contribution per unit of raw material required to produce one unit of a product
If labour hour is a limiting factor	Contribution per unit of labour hour required to produce one unit of a product
If there is a heavy demand for the product	Profit Volume Ratio

6. (i) **Statement of Profitability of DRB Ltd**

	Products (Amount in ₹)				
	D_1	D_2	D_3	D_4	Total
Sales	26,00,000	45,20,000	42,40,000	32,00,000	1,45,60,000
Direct Materials	6,00,000	18,20,000	18,80,000	10,00,000	53,00,000
Direct Wages	8,00,000	20,80,000	12,80,000	12,00,000	53,60,000
Overheads(W.N.2):					
Machine Related	1,60,000	1,56,000	64,000	2,40,000	6,20,000
Batch Related	1,00,000	1,30,000	80,000	1,50,000	4,60,000
Contribution	9,40,000	3,34,000	9,36,000	6,10,000	28,20,000
Product Specific Fixed Overheads	10,00,000	1,00,000	2,00,000	1,00,000	14,00,000
Gross Profit	(60,000)	2,34,000	7,36,000	5,10,000	14,20,000
General Fixed Overheads					6,20,000
Profit					8,00,000

(ii) **Break-even Point**

Total Sale Value of Product 'D_1' = ₹ 26,00,000

Total Contribution of Product 'D_1' = ₹ 9,40,000

Specific Fixed Overheads (Product D_1) = ₹ 10,00,000

Break-even Sales (₹) $= \frac{\text{Specific Fixed Cost}}{\text{Total Contribution}} \text{x} \text{Total Sales Value}$

$= \frac{₹\,10,00,000}{₹\,9,40,000} \text{ x } ₹\,26,00,000$

= ₹ 27,65,957.45

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Break-even Sales (units) = $\frac{₹\ 27,65,957.45}{₹\ 13.00}$ =2,12,766 units

However, production must be done in batches of 100 units. Therefore, **2,128 batches** are required for break even. Due to the production in batches, 34 units (2,128 batches × 100 units – 2,12,766 units) would be produced extra. These 34 units would add extra cost ₹ 282.20 (34 units × ₹ 8.3*). Accordingly, break-even units as calculated above will increase by 22 units $\left(\frac{₹282.20}{₹13.00}\right)$.

(*) $\left(\frac{₹6,00,000 + ₹8,00,000 + ₹1,60,000 + ₹1,00,000}{2,00,000 \text{ units}}\right)$

Break-even units of product 'D_1' is 2,12,788 units (2,12,766 units + 22 units).

Workings

W.N.-1

Calculation Showing Overhead Rates

Overhead's Related Factors	Overhead Cost(₹) [a]	Total No. of Units of Factors [b]	Overhead Rate (₹) [a] / [b]
Machining Hours	6,20,000	15,50,000 hrs.	0.40
Batch Production	4,60,000	9,200 batches	50.00

W.N.-2

Statement Showing - Overhead Costs Related to Product

Particulars	D_1	D_2	D_3	D_4
Machining hrs. related overheads	₹1,60,000 (4,00,000 hrs × ₹0.40)	₹1,56,000 (3,90,000 hrs × ₹0.40)	₹64,000 (1,60,000 hrs × ₹0.40)	₹2,40,000 (6,00,000 hrs × ₹0.40)
Batch related overheads	₹1,00,000 (2,000 batches ×₹50)	₹1,30,000 (2,600 batches ×₹50)	₹80,000 (1,600 batches ×₹50)	₹1,50,000 (3,000 batches × ₹50)

7. **Working Notes**

(1) **Calculation of Actual Sales at Budgeted Prices**

	(₹)
Actual Sales at Actual Price	11,07,000
Less: Sales Price Variance (F)	17,000
Actual Sales at Budgeted Prices	10,90,000

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$$\text{Activity Level} = \frac{\text{Actual Sales at Budgeted Prices}}{\text{Budgeted Sales at Full Capacity}} \times 100$$

$$= \frac{₹10,90,000}{₹13,50,000} \times 100$$

$$= 80.74...\%$$

(2) Segregation of Fixed &Variable Cost Element from Semi-Variable Overheads

$$\text{Variable Overhead} = \frac{\text{Overhead at Full Capacity - Overhead at 75\% Capacity}}{\text{Difference in Activity Level}}$$

$$= \frac{₹3,65,000 - ₹3,23,750}{25}$$

$$= ₹1,650$$

Fixed Overhead = Total SV Overheads at 100% Level – Variable Overheads at 100% level

= ₹ 3,65,000– (₹1,650 × 100)

= ₹ 2,00,000

Flexible Budget at 80.74..%Activity Level

	(Amount in ₹)
Sales	10,90,000
Less:	
Direct Material (₹4,25,000× 80.74..%)	3,43,148
Direct Labour(₹1,85,000× 80.74..%)	1,49,370
Variable Overheads (₹2,15,000× 80.74..%)	1,73,593
Semi-Variable Overheads	
Variable Cost (₹1,650 × 80.74..) [W.N.-2]	1,33,222
Fixed Cost [W.N.-2]	2,00,000
Profit	90,667

8. **Statement Showing 'Pareto Analysis'**

Model	Sales (₹'000)	% of Total Sales	Cumulative Total	Model	Cont. (₹'000)	% of Total Cont.	Cumulative Total %
Pareto Analysis Sales				Pareto Analysis Contribution			
A001	5,100	35.05%	35.05%	B002	690	30.87%	30.87%
B002	3,000	20.62%	55.67%	E005	435	19.47%*	50.34%
C003	2,100	14.43%	70.10%	C003	300	13.42%	63.76%

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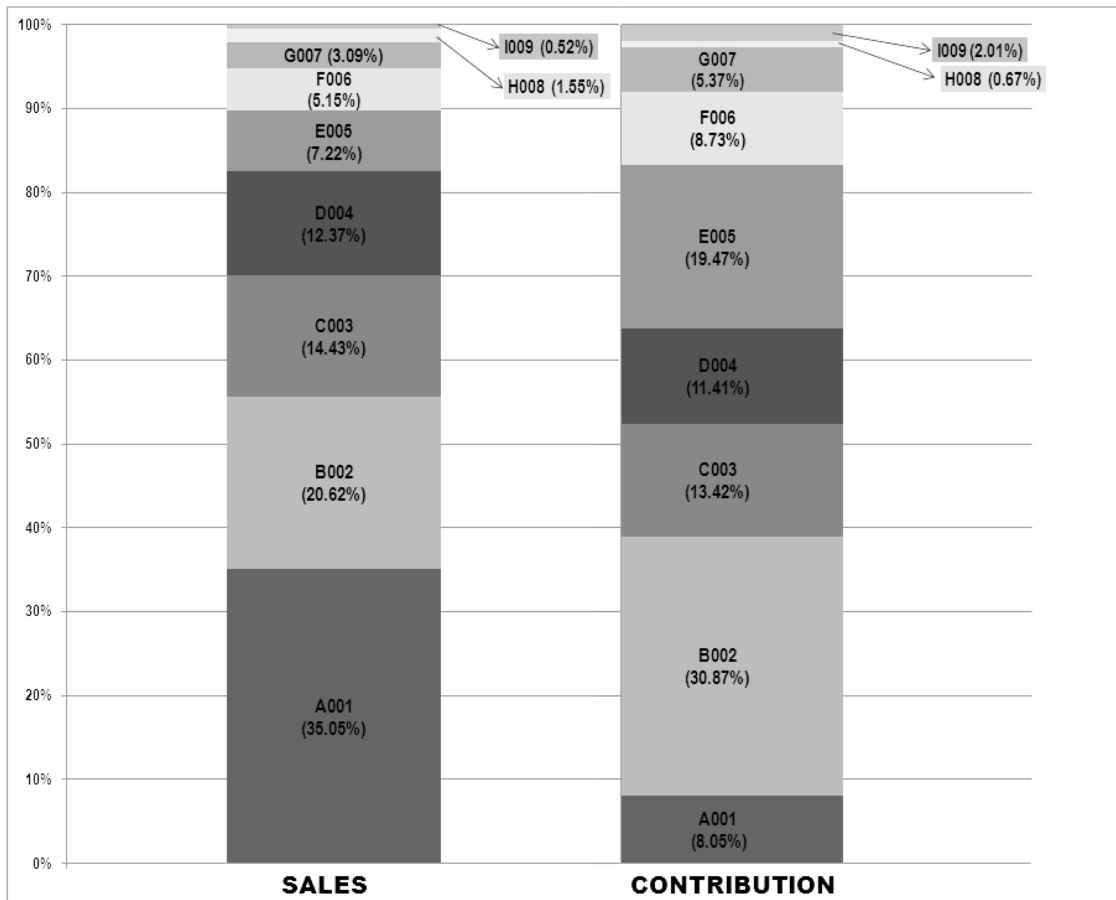
D004	1,800	12.37%	82.47%	D004	255	11.41%	75.17%
E005	1,050	7.22%	89.69%	F006	195	8.73%*	83.90%
F006	750	5.15%	94.84%	A001	180	8.05%	91.95%
G007	450	3.09%	97.93%	G007	120	5.37%	97.32%
H008	225	1.55%	99.48%	I009	45	2.01%	99.33%
I009	75	0.52%	100.00%	H008	15	0.67%	100.00%
	14,550	100.00%			2,235	100.00%	

(*) *Rounding - off difference adjusted.*

Diagram Showing 'Sales and Contribution'(NOT COMPULSORY)



This Diagram is shown for **better understanding** of the concept.

Recommendations

Pareto Analysis is a rule that recommends focus on most important aspects of the decision making in order to simplify the process of decision making. The very purpose of this analysis is to direct attention and efforts of management to the product or area where best returns can be achieved by taking appropriate actions.

Pareto Analysis is based on the 80/20 rule which implies that 20% of the products account for 80% of the revenue. But this is not the fixed percentage rule; in general business sense it means that a few of the products, goods or customers may make up most of the value for the firm.

In present case, five models namely A001, B002, C003, D004 account for 80% of total sales where as 80% of the company's contribution is derived from models B002, E005, C003, D004 and F006.

Models B002 and E005 together account for 50.34% of total contribution but having only 27.84% share in total sales. So, these two models are the key models and should be the top priority of management. Boths C003 and D004 are among the models giving 80% of total contribution as well as 80% of total sales so; they can also be clubbed with B002 and E005 as key models. Management of the company should allocate maximum resources to these four models.

Model F006 features among the models giving 80%of total contribution with relatively lower share in total sales. Management should focus on its promotional activities.

Model A001 accounts for 35.05% of total sales with only 8.05% share in total contribution. Company should review its pricing structure to enhance its contribution.

Models G007, H008 and I009 have lower share in both total sales as well as contribution. Company can delegate the pricing decision of these models to the lower levels of management, thus freeing themselves to focus on the pricing decisions for key models.

9. **Statement of Reconciliation - Budgeted Vs Actual Profit**

Particulars	₹
Budgeted Profit	5,19,000
*Less:*Sales Volume Contribution Planning Variance (Adverse)	52,125
*Less:*Sales Volume Contribution Operational Variance (Adverse)	93,825
*Less:*Sales Price Variance (Adverse)	39,600
*Less:*Variable Cost Variance (Adverse)	29,700
*Less:*Fixed Cost Variance (Adverse)	15,000
Actual Profit	2,88,750

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Workings

Basic Workings

Budgeted Market Share (in %) = $\frac{2,00,000 \text{units}}{4,00,000 \text{units}}$

= 50%

Actual Market Share (in %) = $\frac{1,65,000 \text{units}}{3,75,000 \text{units}}$

= 44%

Budgeted Contribution = ₹ 21,00,000 – ₹ 12,66,000

= ₹ 8,34,000

Average Budgeted Contribution (*per unit)* = $\frac{₹\ 8,34,000}{₹\ 2,00,000}$

= ₹ 4.17

Budgeted Sales Price *per unit* = $\frac{₹\ 21,00,000}{₹\ 2,00,000}$

= ₹10.50

Actual Sales Price *per unit* = $\frac{₹\ 16,92,900}{₹\ 1,65,000}$

= ₹10.26

Standard Variable Cost *per unit* = $\frac{₹\ 12,66,000}{₹\ 2,00,000}$

= ₹ 6.33

Actual Variable Cost *per unit* = $\frac{₹\ 10,74,150}{₹\ 1,65,000}$

= ₹ 6.51

Calculation of Variances

Sales Variances:……….

Volume Contribution Planning* = Budgeted Market Share % × (Actual Industry Sales Quantity *in units* – Budgeted Industry Sales Quantity *in units*) × (Average Budgeted Contribution*per unit*)

= 50% × (3,75,000 units – 4,00,000 units) × ₹ 4.17

= 52,125(A)

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(*)*Market Size Variance*

Volume Contribution Operational**	=	(Actual Market Share % – Budgeted Market Share %)× (Actual Industry Sales Quantity *in units*) × (Average Budgeted Contribution*per unit*)
	=	(44%– 50 %) × 3,75,000 units × ₹ 4.17
	=	93,825 (A)

(**)*Market Share Variance*

Price	=	Actual Sales – Standard Sales
	=	Actual Sales Quantity × (Actual Price – Budgeted Price)
	=	1,65,000 units × (₹ 10.26 – ₹ 10.50)= 39,600(A)
Variable Cost Variances:……….		
Cost	=	Standard Cost for Production – Actual Cost
	=	Actual Production × (Standard Cost*per unit* – Actual Cost*per unit*)
	=	1,65,000units × (₹ 6.33 – ₹ 6.51)
	=	₹ 29,700(A)
Fixed Cost Variances:……….		
Expenditure	=	Budgeted Fixed Cost – Actual Fixed Cost
	=	₹3,15,000 – ₹3,30,000
	=	₹15,000 (A)

Fixed Overhead Volume Variance does not arise in a Marginal Costing system.

10. (i) **Statement Suggesting Fare *per passenger – km* (Each Bus)**

Particulars	Cost per annum (₹)
Fixed Expenses:	
Insurance	55,000.00
Garage Charges	33,000.00
Depreciation	7,70,000.00
Running Expenses:	
Repair and Maintenance	55,000.00
Cost of Lubricants and Sundries	1,38,517.50

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Fuel Cost	5,54,070.00
Salary of Driver and Two Attendants	3,30,000.00
Route Permit Charges	16,500.00
Total Cost *per annum*	19,52,087.50
Add: Markup @ 20% of Total Cost or 16.67% of Total Revenue	3,90,417.50
Total Revenue	23,42,505.00

Rate *per passenger- km* equals to ₹1.395

Workings

Total Passenger Kms = 2,51,85,000

Total Buses = 15

Passenger Kms*per bus* = 16,79,000(2,51,85,000 Kms / 15)

Total Passenger Capacity *per bus* = 42 – 2

= 40

Annual Distance Covered *by a bus* = 41,975 Kms. (16,79,000Kms/40)

(ii) Regulated Fare *per passenger km* is ₹1.35

Profitability Statement for *Each Bus*

Particulars	Year 1 (₹)	Year 2 (₹)
Fixed Expenses:		
Insurance	59,400.00	64,152.00
Garage Charges	35,640.00	38,491.20
Depreciation	7,70,000.00	7,70,000.00
Running Expenses:		
Repair and Maintenance	59,400.00	64,152.00
Cost of Lubricants and Sundries	1,49,598.90	1,61,566.81
Fuel Cost	5,98,395.60	6,46,267.25
Salary of Driver and Two Attendants	3,56,400.00	3,84,912.00
Route Permit Charges	16,500.00	16,500.00
Total Cost ...[A]	20,45,334.50	21,46,041.26
Total Revenue (Regulated) ...[B]	22,66,650.00	22,66,650.00
Gross Margin ...[B] – [A]	2,21,315.50	1,20,608.74
Gross Margin to Total Revenue	9.76%	5.32%

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The gross margin is showing a downward trend because the cost components have taken into the effect of inflation hence increasing year by year but the total revenue has remained stagnant due to Government regulations which resulted in reduction in gross margin per bus.

The company's gross margin to total revenue ratio has come out to be 9.76% and 5.32% in first and second year respectively but initially the company's desired gross margin to total revenue ratio is 16.67% to cover general overheads and sufficient profit. Though the amount of general overheads is not given but we can safely assume that they may also subject to inflation i.e. increase year by year then in such case the company needs to maintain or increase its gross margin per bus to maintain its net profit after general overheads which is not possible in regulated environment. The information about regulated fare in the given case is regarding first two years only but if this regulated fare scenario persists for further years then the project may not be viable for the company.

11. (i) **Transfer Price *per unit* of Product Z that Division W Should Quote *in order to meet* Target Profit**

Quotation for the 40,000 units of product Z should be such that meet Division W's target profit and interest cost on working capital. Therefore the minimum quote for product Z will be calculated as follows:

Particulars	Amount (₹)
Target Profit (given for the year)	2,50,00,000
Add: Interest Cost on Working Capital (₹12,00,00,000 @11.5%)	1,38,00,000
Required Profit	3,88,00,000
Add: Fixed Overhead	4,00,00,000
Target Contribution	7,88,00,000
Less: Contribution Earned --- External Sales {60,000 units × (₹2,500 – ₹1,600)}	5,40,00,000
Contribution Required – Internal Sales	2,48,00,000
Contribution *per unit* of Product Z (₹2,48,00,000 ÷ 40,000 units)	620
Transfer Price of Product Z to Division B (Variable Cost *per unit* + Contribution *per unit*)	2,220

(ii) **The Two Transfer Prices Based on Opportunity Costs**

For the 30,000 units (i.e. maximum capacity – maximum external market demand) at variable cost of production i.e. ₹1,600 per unit.

For the next 10,000 units (i.e. external market demand – maximum possible sale) at market selling price i.e. ₹2,500 per unit.

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12. Let the P_1, P_2 and P_3be the three products to be manufactured. Then the data are as follows:

Products	Product ingredients			
	A	B	C	Inert Ingredients
P_1	5 %	10%	5%	80%
P_2	5%	5%	10%	80%
P_3	20%	5%	10%	65%
Cost per kg (₹)	64	16	40	16

Cost of Product P_1

= 5% × ₹ 64 + 10% × ₹ 16 + 5% × ₹ 40 + 80% × ₹ 16

= ₹19.60 per kg

Cost of Product P2

= 5% × ₹ 64 + 5% × ₹ 16 + 10% × ₹ 40 + 80% × ₹ 16

= ₹20.80 per kg.

Cost of Product P3

= 20% × ₹ 64 + 5% × ₹ 16 + 10% × ₹ 40 + 65% × ₹ 16

= ₹ 28.00 per kg.

Let x_1, x_2, and x_3 be the quantity (in kg) of P_1,P_2,and P3 respectively to be manufactured. The LP problem can be formulated:

Objective function:

Maximise Z = (Selling Price-Cost Price) ×Quantity of Product

= (₹32.60−₹19.60) x_1 + (₹34.80−₹20.80) x_2 + (₹36.00−₹28)x_3

= $13x_1 + 14x_2 + 8x_3$

Subject to Constraints:

$1/20\,x_1 + 1/20x_2 + 1/5x_3 \leq 100$

Or $x_1 + x_2 + 4x_3 \leq 2{,}000$

$1/10\,x_1 + 1/20x_2 + 1/20x_3 \leq 180$

Or $2x_1 + x_2 + x_3 \leq 3{,}600$

$1/20\,x_1 + 1/10x_2 + 1/10x_3 \leq 120$

Or $x_1 + 2x_2 + 2x_3 \leq 2{,}400$

$x_1 \leq 30$

and $x_1, x_2, x_3 \geq 0$

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13. The given information can be tabulated in following transportation problem-

Manager	Assignment			Time Available (Hours)
	TA (₹)	TPA (₹)	GCR (₹)	
C_1	1,800	2,250	2,850	176
C_2	2,100	1,950	1,800	176
C_3	2,400	2,100	2,250	176
Time Required (Hours)	143	154	176	

The given problem is an unbalanced transportation problem. Introducing a dummy assignment to balance it, we get-

Manager	Assignment				Time Available (Hours)
	TA (₹)	TPA (₹)	GCR (₹)	Dummy (₹)	
C_1	1,800	2,250	2,850	0	176
C_2	2,100	1,950	1,800	0	176
C_3	2,400	2,100	2,250	0	176
Time Required (Hours)	143	154	176	55	528

The objective here is to maximize total billing amount of the auditors. For achieving this objective, let us convert this maximization problem into a minimization problem by subtracting all the elements of the above payoff matrix from the highest payoff i.e. ₹2,850.

Manager	Assignment				Time Available (Hours)
	TA (₹)	TPA (₹)	GCR (₹)	Dummy (₹)	
C_1	1,050	600	0	2,850	176
C_2	750	900	1,050	2,850	176
C_3	450	750	600	2,850	176
Time Required (Hours)	143	154	176	55	528

Now, let us apply VAM method to the above matrix for finding the initial feasible solution.

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Manager	Assignment				Time Avail. (Hours)	Difference
	TA (₹)	TPA (₹)	GCR (₹)	Dummy (₹)		
C_1	1,050	600	0 [176]	2,850	176/0	600 - -
C_2	750	900 [121]	1,050	2,850 [55]	176/55/0	150, 150 1,950
C_3	450 [143]	750 [33]	600	2,850	176/33/0	150, 300, 2,100
Time Required	143/0	154/121/0	176/0	55/0	528	
Difference	300	150	600	0		
	300	150	-	0		
	-	150	-	0		

The initial solution is given below. It can be seen that it is a degenerate solution since the number of allocation is 5. In order to apply optimality test, the total number of allocations should be 6 (m + n -1). To make the initial solution a non-degenerate, we introduce a very small quantity in the least cost independent cell which is cell of C_3, GCR.

Manager	Assignment			
	TA (₹)	TPA (₹)	GCR (₹)	Dummy (₹)
C_1	1,050	600	0 [176]	2,850
C_2	750	900 [121]	1,050	2,850 [55]
C_3	450 [143]	750 [33]	600 [e]	2,850

Let us test the above solution for optimality-

(u_i + v_j) Matrix for Allocated / Unallocated Cells

					u_i
	-150	150	0	2,100	-600
	600	900	750	2,850	150
	450	750	600	2,700	0
v_j	450	750	600	2,700	

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Now we calculate $\Delta_{ij} = C_{ij} - (u_i + v_j)$ for non basic cells which are given in the table below-

Δ_{ij} Matrix

1,200	450		750
150		300	
			150

Since, all allocations in $\Delta_{ij}= C_{ij}-(u_i+v_j)$are non negative, the allocation is optimal. The allocation of assignments to managers and their billing amount is given below:

Manager	Assignment	Billing Amount
C_1	Global Compliance & Reporting (GCR)	₹5,01,600 (176 hrs. ×₹2,850)
C_2	Tax Performance Advisory (TPA)	₹2,35,950 (121 hrs. ×₹1,950)
C_3	Tax Accounting (TA)	₹3,43,200 (143 hrs. ×₹2,400)
C_3	Tax Performance Advisory (TPA)	₹69,300 (33 hrs. ×₹2,100)
	Total Billing	₹11,50,050

14. (i) **Invalid**

Reason: As per the rules of network construction, parallel activities between two events, without intervening events, are prohibited. Dummy activities are needed when two or more activities have same initial and terminal events. Dummy activities donot consume time or resources.

(ii) **Valid**

Reason: As per the conventions adopted in drawing networks, the head event or terminal node always has a number higher than that of initial node or tail event.

(iii) **Invalid**

Reason: The difference between the latest event time and the earliest event time is termed as slack of an event. Free float is determined by subtracting head event slack from the total float of an activity.

(iv) **Invalid**

Reason: For every critical activity in a network, the earliest start time and the latest starttime is same and also the earliest finish time and the latest finish time is same.

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(v) **Invalid**

Reason: The optimum duration is the time period in which the total cost of the project is minimum.

(vi) **Valid**

Reason: Resource leveling is a network technique used for reducing the requirement of a particular resource due to its paucity or insufficiency within a constraint on the project duration. The process of resource leveling utilize the large floats available on non-critical activities of the project and cuts down the demand of the resource.

15. **Allocation of Random Numbers**

Raw Material			Wages & Other Variable Overheads			Sales		
Mid Point	Cum. Prob.	Random Nos.	Mid Point	Cum. Prob.	Random Nos.	Mid Point	Cum. Prob.	Random Nos.
9	0.2	0 – 1	12	0.3	0 – 2	36	0.1	0
11	0.5	2 – 4	14	0.8	3 – 7	40	0.4	1 – 3
13	0.8	5 – 7	16	1.0	8 – 9	44	0.8	4 – 7
15	1.0	8 – 9				48	1.0	8 – 9

Simulation Table (₹ in 000)

Month	Raw Material	Wages & Other V.O	Sales	Fixed Cost	Net Cash Flow	Cash Balancing (Opening ₹40 thousand)
1	11	12	36	15	-2	38
2	11	14	44	15	+4	42
3	9	16	44	15	+4	46
4	9	12	36	15	0	46
5	11	16	40	15	-2	44
6	13	16	48	15	+4	**48**

16. **(i)** Variable cost per unit that will be effected by learning and experience curve is ₹2,200 (₹4,400 – 50% of ₹ 4,400).

Let, 'r' be the learning curve rate.

No. of Batch (x)	Cumulative Average Cost *per unit* (y)
1	2,200
2	2,200 r
4	2,200 r^2

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If 2,200 r^2 = ₹1,920 (₹4,120 – 50% of ₹ 4,400)

r^2 = 0.8727

r = 0.934

Therefore, Learning Curve Effect = 93% (rounded off)

(ii) **Calculation of Optimum Price**

Price *per unit* (₹)	Demand (units)	Variable Cost *per unit* * [W.N.] (₹)	Variable Cost *per unit* ** (₹)	Total Variable Cost *per unit* (₹)	Contribution *per unit* (₹)	Total Contribution (₹)
11,100.00	1,000	2,200.00	2,200.00	4,400.00	6,700.00	67,00,000
10,700.00	2,000	2,046.00	2,200.00	4,246.00	6,454.00	1,29,08,000
9,600.00	3,000	1960.86	2,200.00	4,160.86	5,439.14	1,63,17,420
8,700.00	4,000	1,902.78	2,200.00	4,102.78	4,597.22	1,83,88,880

(*) This represents variable cost part which is affected by the learning and experience curve effect.

(**) This represents variable cost part which is not affected by the learning and experience curve effect.

Working Note [W.N.]

Variable Cost *per unit*

Output in Batches (x)	Average Cost of the First Unit (a)	$x^{-0.1047}$	Cumulative Average Cost *per unit* (y)
1	2,200	1.0000	2,200.00
2	2,200	0.9299	2,046.00
3	2,200	0.8913	1,960.86
4	2,200	0.8649	1,902.78

y = ax^b

Where,

y = Cumulative average unit costs

a = Average cost of the first unit

x = Cumulative number of batches

b = Log of learning ratio ÷ Log of 2

= log 0.93 ÷ log 2

= −0.0315 ÷ 0.3010 = −0.1047

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PAPER – 6: INFORMATION SYSTEMS CONTROL AND AUDIT

QUESTIONS

Note: Update on Section 66A of the IT Act, 2000

As per the decision of the Supreme Court dated 24th March, 2015; Section 66A of Information Technology Act, 2000 (Punishment for sending offensive messages through communication service, etc.) has been declared ***Unconstitutional*** as it is violative of Article 19(1)(a) related to freedom of speech and expressions. Now comments on social networking sites will not be offensive unless they come under the provisions of the Indian Penal Code, 1860.

Concepts of Governance and Management of Information Systems

1. Discuss different levels of managerial activity that are carried out in an enterprise.
2. Discuss key benefits of COBIT 5 framework.
3. As an internal auditor, what shall be your perspective while evaluating IT Governance of an enterprise?

Information System Concepts

4. Discuss major areas of Computer-based applications.
5. Discuss different components of ERP (Enterprise Resource Planning) and its benefits.
6. Discuss different attributes of Information.

Protection of Information Systems

7. Differentiate between Detective Controls and Corrective Controls.
8. Discuss the impact of Technology on Internal Controls.
9. Discuss major techniques to commit cyber frauds.

Business Continuity Planning and Disaster Recovery Planning

10. Discuss the different phases involved in the development of a Business Continuity Plan.
11. Why documentation is required in Business Continuity Management (BCM)? Which documents are classified as being part of the BCM system?
12. Discuss Business Impact Analysis (BIA).

Acquisition, Development and Implementation of Information Systems

13. What do you understand by "Incremental Model"? Discuss its strengths and weaknesses also.
14. Discuss majorly used System Development Tools.

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15. How can 'System Maintenance' under System Development Life Cycle (SDLC) be categorized?

Auditing of Information Systems

16. Why is there a need for audit of Information Systems?
17. Discuss the System Control Audit Review File (SCARF) technique used in the audit of Information Systems.

Information Technology Regulatory Issues

18. Discuss the provision given in IT (Amendment) Act 2008 that gives "Power to make rules by Central Government in respect of Electronic Signature".
19. Discuss the guidelines recommended by Securities and Exchange Board of India (SEBI) to conduct audit of systems.

Emerging Technologies

20. What are the emerging threats under "Bring Your Own Device (BYOD)"?

Short Note Based Questions

21. Write short notes on following:
    (a) Benefits of Governance of Enterprise IT (GEIT)
    (b) Planning Languages in Decision Support Systems (DSS)
    (c) Objectives and Goals of Business Continuity Planning (BCP)
    (d) Strengths of Agile Model
    (e) Auditor's role in System Development Life Cycle (SDLC)
22. Differentiate between the following:
    (a) Full Backup and Incremental Backup
    (b) Open System and Closed System
    (c) Explicit Knowledge and Tacit Knowledge
    (d) Quality Assurance Management Control and Security Management Control
    (e) Program Debugging and Program Testing

Questions based on the Case Studies

23. PQR Company is a pharmaceutical retail chain having many branches located in different places for its operation. Its business processes are cumbersome and tedious as it has multiple sources of procurement and supply destinations. The Chief Executive Officer (CEO) of company feels that existing information system does not meet its present requirements. He seeks for high-end solution to streamline and integrate its operation

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processes and information flow to synergize all its major resources. Further, he expects that the new system should provide a structured environment in which decisions concerning demand, supply, operational, personnel, finance, logistics etc. are fully supported by accurate and reliable information. The company follows the best practices of System Development Life Cycle (SDLC), which consists of various phases starting from preliminary investigation till post implementation review, controls and security aspects. The CEO of the company appoints a committee of three persons - IT expert, a Security expert and an Auditor of the company in order to suggest the following:

(a) List the activities to be performed during the phase of System Requirements Analysis.

(b) Discuss major Boundary Control techniques that should be used in user control?

24. ABC is a leading company in the manufacturing of food items. The company is in the process of automation of its various business processes. During this phase, technical consultant of the company has highlighted the importance of information security and has suggested introducing it right from the beginning. He has also suggested to perform the risk assessment activity and accordingly, to mitigate the assessed risk. For carrying out all these suggestions, various best practices have been followed by the company. In addition, after each activity, appropriate standards' compliances have been tested to check the quality of each process. Various policies related with business continuity planning and disaster recovery planning has been implemented to ensure three major expectations from the software, namely, resist, tolerate and recover.

    Read the above carefully and answer the following:

    (a) What are the major suggestions given by the technical consultant? How the company is implementing these suggestions?

    (b) Discuss Recovery Plan under Business Continuity Planning.

    (c) What should be the major components of a good information security policy, as per your opinion?

25. ABC Industries Ltd., a company engaged in a business of manufacture and supply of automobile components to various automobile companies in India, had been developing and adopting office automation systems, at random and in isolated pockets of its departments. The company has recently obtained three major supply contracts from International Automobile companies and the top management has felt that the time is appropriate for them to convert its existing information system into a new one and to integrate all its office activities. One of the main objectives of taking this exercise is to maintain continuity of business plans even while continuing the progress towards e-governance.

    (a) When the existing information system is to be converted into a new system, what are the activities involved in the conversion process?

    (b) What are the different office activities that can be performed under Office Automation Systems (OAS)?

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(c) What is meant by Business Continuity Planning? Explain the areas covered by Business Continuity.

SUGGESTED ANSWERS/HINTS

1. There are three levels of managerial activity in an enterprise which are as follows:

- **Strategic Planning:** Strategic Planning is defined as the process of deciding on objectives of the enterprise, on changes in these objectives, on the resources used to attain these objectives, and on the policies that are to govern the acquisition, use, and disposition of these resources. Strategic planning is the process by which top management determines overall organizational purposes and objectives and how they are to be achieved. Corporate-level strategic planning is the process of determining the overall character and purpose of the organization, the business it will enter and leave, and how resources will be distributed among those businesses.
- **Management Control:** Management Control is defined as the process by which managers assure that resources are obtained and used effectively and efficiently in the accomplishment of the enterprise's objectives.
- **Operational Control:** Operational Control is defined as the process of assuring that specific tasks are carried out effectively and efficiently.

IT strategic plans provide direction to deployment of information systems and it is important that key functionaries in the enterprise are aware and are involved in its development and implementation. Management should ensure that IT long and short-range plans are communicated to business process owners and other relevant parties across the enterprise. Management should establish processes to capture and report feedback from business process owners and users regarding the quality and usefulness of long and short-range plans. The feedback obtained should be evaluated and considered in future IT planning.

2. The key benefits of COBIT 5 framework are as follows:

- A comprehensive framework such as COBIT 5 enables enterprises in achieving their objectives for the governance and management of enterprise IT.
- The best practices of COBIT 5 help enterprises to create optimal value from IT by maintaining a balance between realizing benefits and optimizing risk levels and resource use.
- Further, COBIT 5 enables IT to be governed and managed in a holistic manner for the entire enterprise, taking in the full end-to-end business and IT functional areas of responsibility, considering the IT related interests of internal and external stakeholders.

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- COBIT 5 helps enterprises to manage IT related risk and ensures compliance, continuity, security and privacy.
- COBIT 5 enables clear policy development and good practice for IT management including increased business user satisfaction.
- The key advantage in using a generic framework such as COBIT 5 is that it is useful for enterprises of all sizes, whether commercial, not-for-profit or in the public sector.
- COBIT 5 supports compliance with relevant laws, regulations, contractual agreements and policies.

3. IT Governance can be evaluated by both external as well internal auditors. The Institute of Internal Auditors (IIA) issues the guidance that outlines specific areas and critical aspects relating to governance structure and practices, which can be reviewed as part of internal audit. These are briefly explained here.

   - **Leadership:** The following aspects need to be verified by the auditor:
     - Evaluate the relationship between IT objectives and the current/strategic needs of the organization and the ability of IT leadership to effectively communicate this relationship to IT and organizational personnel.
     - Assess the involvement of IT leadership in the development and on-going execution of the organization's strategic goals.
     - Determine how IT will be measured in helping the organization achieve these goals.
     - Review how roles and responsibilities are assigned within the IT organization and how they are executed.
     - Review the role of senior management and the board in helping establish and maintain strong IT governance.
   - **Organizational Structure:** The following aspects need to be assessed by the auditor:
     - Review how organization management and IT personnel are interacting and communicating current and future needs across the organization.
     - This should include the existence of necessary roles and reporting relationships to allow IT to meet the needs of the organization, while providing the opportunity to have requirements addressed via formal evaluation and prioritization. In addition, how IT mirrors the organization structure in its enterprise architecture should also be included.
   - **Processes:** The following aspects need to be checked by the auditor:
     - Evaluate IT process activities and the controls in place to mitigate risks to the organization and whether they provide the necessary assurance regarding

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processes and underlying systems.

- What processes are used by the IT organization to support the IT environment and consistent delivery of expected services?

- **Risks:** The following aspects need to be reviewed by the auditor:
  - Review the processes used by the IT organization to identify, assess, and monitor/mitigate risks within the IT environment.
  - Additionally, determine the accountability that personnel have within risk management and how well these expectations are being met.
- **Controls:** The following aspects need to be verified by the auditor:
  - Assess key controls that are defined by IT to manage its activities and the support of the overall organization.
  - Ownership, documentation, and reporting of self-validation aspects should be reviewed by the internal audit activity.
  - Additionally, the control set should be robust enough to address identified risks based on the organization's risk appetite and tolerance levels, as well as any compliance requirements.
- **Performance Measurement/Monitoring:** The following aspects need to be verified by the auditor:
  - Evaluate the framework and systems in place to measure and monitor organizational outcomes where support from IT plays an important part in the internal outputs in IT operations and developments.

4. Major areas of Computer based applications are Finance and Accounting, Marketing and Sales, Manufacturing, Inventory/Stock Management, Human Resource Management etc., which are given as follows:

- **Finance and Accounting –** The main goal of this subsystem is to ensure the financial viability of the organization, enforce financial discipline and plan and monitor the financial budget. It also helps in forecasting revenues, determining the best resources and uses of funds and managing other financial resources. Typical sub-application areas in finance and accounting are - Financial accounting; General ledger; Accounts receivable/payable; Asset accounting; Investment management; Cash management; Treasury management; Fund management and Balance sheet.
- **Marketing and Sales –** The objective of this subsystem is to maximize the sales and ensure customer satisfaction. The marketing system facilitates the chances of order procurement by marketing the products of the company, creating new customers and advertising the products. The sales department may use an order processing system to keep the status and track of orders, generate bills for the orders executed and delivered to the customer, strategies for rendering services

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during warranty period and beyond, analyzing the sales data by category such as by region, product, sales manor sales value.

- **Production or Manufacturing –** The objective of this subsystem is to optimally deploy man, machine and material to maximize production or service. The system generates production schedules and schedules of material requirements, monitors the product quality, plans for replacement or overhauling the machinery and also helps in overhead cost control and waste control.
- **Inventory /Stores Management -** The inventory management system is designed with a view to keeping the track of materials in the stores. The system is used to regulate the maximum and minimum level of stocks, raise alarm at danger level stock of any material, give timely alert for re-ordering of materials with optimal re-order quantity and facilitate various queries about inventory like total inventory value at any time, identification of important items in terms stock value (ABC analysis), identification most frequently moving items (XYZ analysis) etc.
- **Human Resource Management -** Human resource is the most valuable asset for an organization. Effective and efficient utilization of manpower in a dispute-free environment in this key functional area ensures to facilitate disruption free and timely services in business. Human Resource Management System (HRMS) aims to achieve this goal. Skill database maintained in HRM system, with details of qualifications, training, experience, interests etc. helps management for allocating manpower to right activity at the time of need or starting a new project. This system also keeps track of employees' output or efficiency. Administrative functions like keeping track of leave records or handling other related functions are also included HRM system. An HRM system may have the following modules – Personnel administration; Recruitment management; Travel management; Benefit administration; Salary administration; Promotion management etc.

5. **Enterprise Resource Planning (ERP)** is process management software that allows an organization to use a system of integrated applications to manage the business and automate many back-office functions related to technology, services and human resources. ERP software integrates all facets of an operation, including product planning, development, manufacturing, sales and marketing. ERP model consists of four components which are implemented through a methodology and are as follows:

   (i) Software Component: The software component is the component that is most visible part and consists of several modules such as Finance, Human Resource, Supply Chain Management, Supplier Relationship Management, Customer Relationship, and Business Intelligence.

   (ii) Process Flow: It is the model that illustrates the way how information flows among the different modules within an ERP system. By creating this model makes it easier to understand how ERP work.

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(iii) **Customer mindset:** By implementing ERP system, the old ways for working which user understand and comfortable with; have to be changed and may lead to users' resistance. For example, some users may say that they have spent many years doing an excellent job without help from ERP system. In order to lead ERP implementation to succeed, the company needs to eliminate negative value or belief that users may carry toward utilizing new system.

(iv) **Change Management:** In ERP implementation, change needs to be managed at several levels - User attitude; resistance to change; and Business process changes.

Benefits of ERP are as follows:

- Streamlining processes and workflows with a single integrated system.
- Reduce redundant data entry and processes and in other hand it shares information across the department.
- Establish uniform processes that are based on recognized best business practices.
- Improved workflow and efficiency.
- Improved customer satisfaction based on improved on-time delivery, increased quality, shortened delivery times.
- Reduced inventory costs resulting from better planning, tracking and forecasting of requirements.
- Turn collections faster based on better visibility into accounts and fewer billing and/or delivery errors.
- Decrease in vendor pricing by taking better advantage of quantity breaks and tracking vendor performance.
- Track actual costs of activities and perform activity based costing.
- Provide a consolidated picture of sales, inventory and receivables.

6. **Attributes of Information:** Some of the important attributes of useful and effective information are as follows:

- **Availability -** Information is useless if it is not available at the time of need. Database is a collection of files which is collection of records and data from where the required information is derived for useful purpose.
- **Purpose/Objective -** Information must have purposes/objective at the time it is transmitted to a person or machine, otherwise it is simple data. The basic objective of information is to inform, evaluate, persuade, and organize that further helps in decision making, generating new concepts and ideas, identify and solve problems, planning, and controlling which are needed to direct human activity in business enterprises.

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- **Mode and format -** The mode of communicating information to humans should be in such a way that it can be easily understand by the people. The mode may be in the form of voice, text and combination of these two. Format also plays an important role in communicating the idea. It should be designed in such a way that it assists in decision making, solving problems, initiating planning, controlling and searching. According to the type of information the different formats can be used e.g. diagrams, graphs, curves are best suited for representing the statistical data. Format of information should be simple, relevant and should highlight important points but should not be too cluttered up.
- **Current/Updated -** The information should be refreshed from time to time as it usually rots with time and usage. For example, the running score sheet of a cricket match available in Internet sites should be refreshed at fixed interval of time so that the current score will be available. Similar is the case with broker who wants the latest information about the stock market.
- **Rate -** The rate of transmission/reception of information may be represented by the time required to understand a particular situation. Useful information is the one which is transmitted at a rate which matches with the rate at which the recipient wants to receive. For example- the information available from internet site should be available at a click of mouse, one should wait for it an hour.
- **Frequency -** The frequency with which information is transmitted or received affects its value. For example- the weekly reports of sales shows little change as compared to the quarterly and contribute less for accessing salesman capability.
- **Completeness and Adequacy -** The information provided should be complete and adequate in itself because only complete information can be used in policy making. For example-the position of student in a class can be find out only after having the information of the marks of all students and the total number of students in a class.
- **Reliability -** It is a measure of failure or success of using information for decision-making. If information leads to correct decision on many occasions, we say the information is reliable.
- **Validity -** It measures how close the information is to the purpose for which it asserts to serve. For example, the experience of employee supports in evaluating his performance.
- **Quality -** It means the correctness of information. For example, an over-optimistic manager may give too high estimates of the profit of product which may create problem in inventory and marketing.
- **Transparency -** It is essential in decision and policy making. For example, total amount of advance does not give true picture of utilization of fund for decision about future course of action; rather deposit-advance ratio is perhaps more transparent information in this matter.

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- **Value of Information -** It is defined as difference between the value of the change in decision behavior caused by the information and the cost of the information. In other words, given a set of possible decisions, a decision-maker may select one on basis of the information at hand. If new information causes a different decision to be made, the value of the new information is the difference in value between the outcome of the old decision and that of the new decision, less the cost of obtaining the information.

7. **Detective Controls:** These controls are designed to detect errors, omissions or malicious acts that occur and report the occurrence. An example of a detective control would be a use of automatic expenditure profiling where management gets regular reports of spend to date against profiled spend. The main characteristics of such controls are given as follows:

   - Clear understanding of lawful activities so that anything which deviates from these is reported as unlawful, malicious, etc;
   - An established mechanism to refer the reported unlawful activities to the appropriate person or group;
   - Interaction with the preventive control to prevent such acts from occurring; and
   - Surprise checks by supervisor.

   Examples of detective controls include Hash totals; Check points in production jobs; Echo control in telecommunications; Error message over tape labels; Duplicate checking of calculations; Periodic performance reporting with variances; Past-due accounts report; The internal audit functions; Intrusion detection system; Cash counts and bank reconciliation; and Monitoring expenditures against budgeted amount.

   Corrective Controls: Corrective controls are designed to reduce the impact or correct an error once it has been detected. Corrective controls may include the use of default dates on invoices where an operator has tried to enter the incorrect date. A Business Continuity Plan (BCP) is considered to be a corrective control. The main characteristics of the corrective controls are minimizing the impact of the threat; Identifying the cause of the problem; Providing Remedy to the problems discovered by detective controls; Getting feedback from preventive and detective controls; Correcting error arising from a problem; and Modifying the processing systems to minimize future occurrences of the incidents. Examples of Corrective Controls are Contingency planning; Backup procedure; Rerun procedures; Change input value to an application system, and Investigate budget variance and report violations.

8. The impact of Technology on Internal Controls is as follows:

   - **Competent and Trustworthy Personnel:** Personnel should have proper skill and knowledge to discharge their duties. Substantial power is often vested in the errors responsible for the computer-based information systems developed, implemented, operated, and maintained within organizations.

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- **Segregation of Duties:** In a manual system, during the processing of a transaction, there are split between different people, such that one person does not process a transaction right from start to finish. However, in a computerised system, the auditor should also be concerned with the segregation of duties within the IT department. As a basic control, segregation of duties prevents or detects errors or irregularities. Within an IT environment, the staff in the IT department of an enterprise will have a detailed knowledge of the interrelationship between the source of data, how it is processed and distribution and use of output.
- **Authorization Procedures:** In manual systems, auditors evaluate the adequacy of procedures for authorization of examining the work of employees. In computer systems, authorization procedures often are embedded within a computer program. For example: In some on-line transaction systems, written evidence of individual data entry authorisation, e.g. a supervisor's signature, may be replaced by computerised authorisation controls such as automated controls written into the computer programs (e.g. programmed credit limit approvals).
- **Adequate Documents and Records:** In a manual system, adequate documents and records are needed to provide an audit trail of activities within the system. In computer systems, documents might not be used to support the initiation, execution, and recording of some transactions. Thus, no visible audit or management trail would be available to trance the transactions in a computerized system.
- **Physical Control over Assets and Records:** Physical control over access and records is critical in both manual systems and computer systems. In the manual systems, protection from unauthorised access was through the use of locked doors and filing cabinets. Computerised financial systems have not changed the need to protect the data. A client's financial data and computer programs can all be maintained at a single site – namely the site where the computer is located. This concentration of information systems assets and records also increases the losses that can arise from computer abuse or a disaster.
- **Adequate Management Supervision:** In a manual system, management supervision of employee activities is relatively straightforward as the managers and the employees are often at the same physical location. In computer system, however, data communication facilities can be used to enable employees to be closer to the customers they service. Thus supervision of employees might have to be carried our remotely. The Management's supervision and review helps to deter and detect both errors and fraud.
- **Independent Checks on Performance:** In manual systems, independent checks are carried out because employees are likely to forget procedures, make genuine mistakes, become careless, or intentionally fail to follow prescribed procedures. If the program code in a computer system is authorized, accurate, and complete; the system will always follow the designated procedures in the absence of some other type of failure like hardware or systems software failure.

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- **Comparing Recorded Accountability with Assets:** Data and the assets that the data purports to represent should periodically be compared to determine whether incompleteness or inaccuracies in the data exist or whether shortages or excesses in the assets have occurred. In a manual system, independent staff prepares the basic data used for comparison purposes. In a computer system, however, software is used to prepare this data. Again, internal controls must be implemented to ensure the veracity of program code, because traditional separation of duties no longer applies to the data being prepared for comparison purposes.
- **Delegation of Authority and Responsibility:** A clear line of authority and responsibility is an essential control in both manual and computer systems. In a computer system, however, delegating authority and responsibility in an unambiguous way might be difficult because some resources are shared among multiple users. Further, more users are developing, modifying, operating, and maintaining their own application systems instead of having this work performed by IS professionals.

9. Following are the major techniques to commit cyber frauds:

- **Hacking:** It refers to unauthorized access and use of computer systems, usually by means of personal computer and a telecommunication network. Normally, hackers do not intend to cause any damage.
- **Cracking:** Crackers are hackers with malicious intentions, which means, un-authorized entry. Now across the world hacking is a general term, with two nomenclatures namely: Ethical and Un-ethical hacking. Un-ethical hacking is classified as Cracking.
- **Data Diddling:** Changing data before, during, or after it is entered into the system in order to delete, alter, or add key system data is referred as data diddling.
- **Data Leakage:** It refers to the unauthorized copying of company data such as computer files.
- **Denial of Service (DoS) Attack:** It refers to an action or series of actions that prevents access to a software system by its intended/authorized users; causes the delay of its time-critical operations; or prevents any part of the system from functioning.
- **Internet Terrorism:** It refers to the using Internet to disrupt electronic commerce and to destroy company and individual communications.
- **Logic Time Bombs:** These are the program that lies idle until some specified circumstances or a particular time triggers it. Once triggered, the bomb sabotages the system by destroying programs, data or both.
- **Masquerading or Impersonation:** In this case, perpetrator gains access to the system by pretending to be an authorized user.

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- **Password Cracking:** Intruder penetrates a system's defence, steals the file containing valid passwords, decrypts them and then uses them to gain access to system resources such as programs, files and data.
- **Piggybacking:** It refers to the tapping into a telecommunication line and latching on to a legitimate user before s/he logs into the system.
- **Round Down:** Computer rounds down all interest calculations to 2 decimal places. Remaining fraction is placed in account controlled by perpetrator.
- **Scavenging or Dumpster Diving:** It refers to the gaining access to confidential information by searching corporate records.
- **Social Engineering Techniques:** In this case, perpetrator tricks an employee into giving out the information needed to get into the system.
- **Super Zapping:** It refers to the unauthorized use of special system programs to bypass regular system controls and performs illegal acts.
- **Trap Door:** In this technique, perpetrator enters in the system using a back door that bypasses normal system controls and perpetrates fraud.

10. The eight phases involved in the development of a Business Continuity Plan (BCP) are as follows:

- **Phase 1 – Pre-Planning Activities (Project Initiation):** This Phase is used to obtain an understanding of the existing and projected computing environment of the organization. This enables the project team to refine the scope of the project and the associated work program; develop project schedules; and identify and address any issues that could have an impact on the delivery and the success of the project.

  During this phase, a Steering Committee should be established that have the overall responsibility for providing direction and guidance to the Project Team. The Project Manager should work with the Steering Committee in finalizing the detailed work plan and developing interview schedules for conducting the Security Assessment and the Business Impact Analysis. Two other key deliverables of this phase are the development of a policy to support the recovery programs; and an awareness program to educate management and senior individuals who will be required to participate in the project.
- **Phase 2 – Vulnerability Assessment and General Definition of Requirements:** This phase addresses measures to reduce the possibility of disaster occurrence, rather than concentrating primarily on minimizing impact of an actual disaster. This phase includes the following key tasks:
  - A thorough Security Assessment of the computing and communications environment including personnel practices; physical security; operating procedures; backup and contingency planning; systems development and maintenance; database security; data and voice communications security;

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systems and access control software security; insurance; security planning and administration; application controls; and personal computers.

- The Security Assessment will enable the project team to improve any existing emergency plans and disaster prevention measures and to implement required emergency plans and disaster prevention measures where none exist.
- Present findings and recommendations resulting from the activities of the Security Assessment to the Steering Committee so that corrective actions can be initiated in a timely manner.
- Define the scope of the planning effort.
- Analyze, recommend and purchase recovery planning and maintenance software required to support the development of the plans and to maintain the plans current following implementation.
- Develop a Plan Framework.
- Assemble Project Team and conduct awareness sessions.

- **Phase 3 – Business Impact Assessment (BIA):** A Business Impact Assessment (BIA) of all business units that are part of the business environment enables the project team to identify critical systems, processes and functions; assess the economic impact of incidents and disasters that result in a denial of access to systems services and other services and facilities; and assess the "pain threshold," that is, the length of time business units can survive without access to systems, services and facilities. The BIA Report should be presented to the Steering Committee that identifies critical service functions and the timeframes in which they must be recovered after interruption. The BIA Report should then be used as a basis for identifying systems and resources required to support the critical services provided by information processing and other services and facilities.
- **Phase 4 – Detailed Definition of Requirements:** During this phase, a profile of recovery requirements is developed and is used as a basis for analyzing alternative recovery strategies and identifying resources required to support critical functions identified in Phase 3. This profile should include hardware (mainframe, data and voice communications and personal computers), software (vendor supplied, in-house developed, etc.), documentation (DP, user, procedures), outside support (public networks, DP services, etc.), facilities (office space, office equipment, etc.) and personnel for each business unit. Recovery Strategies will be based on short term, intermediate term and long term outages. Another key deliverable of this phase is the definition of the plan scope, objectives and assumptions.
- **Phase 5 – Plan Development:** During this phase, recovery plans components are defined and plans are documented. This phase also includes the implementation of changes to user procedures, upgrading of existing data processing operating procedures required to support selected recovery strategies and alternatives,

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vendor contract negotiations (with suppliers of recovery services) and the definition of Recovery Teams, their roles and responsibilities. Recovery standards are also be developed during this phase.

- **Phase 6 – Testing/Exercising Program:** The plan Testing/Exercising Program is developed during this phase. Testing/exercising goals are established and alternative testing strategies are evaluated. Testing strategies tailored to the environment should be selected and an on-going testing program should be established.
- **Phase 7 – Maintenance Program:** Maintenance of the plans is critical to the success of an actual recovery. The plans must reflect changes to the environments that are supported by the plans. It is critical that existing change management processes are revised to take recovery plan maintenance into account. In areas, where change management does not exist, change management procedures will be recommended and implemented. Many recovery software products take this requirement into account.
- **Phase 8 – Initial Plan Testing and Implementation:** Once plans are developed, initial tests of the plans are conducted and any necessary modifications to the plans are made based on an analysis of the test results. Specific activities of this phase include defining the test purpose/approach; identifying test teams; structuring the test; conducting the test; analyzing test results; and modifying the plans as appropriate. As the recovery strategies are defined, specific testing procedures should be developed to ensure that the written plans are comprehensive and accurate.

11. It is important to keep preparations including documentation, up-to-date for the following reasons:

- Contracts and agreements are needed to reflect the changes.
- If additional equipment is needed, it must be maintained and periodically replaced when it is no longer dependable or no longer fits the organization's architecture.
- The BCM maintenance process demonstrate the documented evidence of the proactive management and governance of the enterprise's business continuity program; the key people who are to implement the BCM strategy and plans are trained and competent; the monitoring and control of the BCM risks faced by the enterprise; and the evidence that material changes to the enterprise's structure, products and services, activities, purpose, staff and objectives have been incorporated into the enterprise's business continuity and incident management plans.

The following documents (representative only) are classified as being part of the Business Continuity Management system:

- The business continuity policy;
- The business continuity management system;

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- The business impact analysis report;
- The risk assessment report;
- The aims and objectives of each function;
- The activities undertaken by each function;
- The business continuity strategies;
- The overall and specific incident management plans;
- The business continuity plans;
- Change control, preventative action, corrective action, document control and record control processes;
- Local Authority Risk Register;
- Exercise schedule and results;
- Incident log; and
- Training program.

12. **Business Impact Analysis (BIA):** Business Impact Analysis (BIA) is essentially a means of systematically assessing the potential impacts resulting from various events or incidents. The process of BIA determines and documents the impact of a disruption of the activities that support its key products and services. It enables the business continuity team to identify critical systems, processes and functions, assess the economic impact of incidents and disasters that result in a denial of access to the system, services and facilities, and assess the "pain threshold, "that is, the length of time business units can survive without access to the system, services and facilities. For each activity supporting the delivery of key products and services within the scope of its Business Continuity Management (BCM) program, the enterprise should:

- assess the impacts that would occur if the activity was disrupted over a period of time;
- identify the maximum time period after the start of a disruption within which the activity needs to be resumed;
- identify critical business processes;
- assess the minimum level at which the activity needs to be performed on its resumption;
- identify the length of time within which normal levels of operation need to be resumed; and
- identify any inter-dependent activities, assets, supporting infrastructure or resources that have also to be maintained continuously or recovered over time.

The enterprise should have a documented approach to conduct BIA. The enterprise should document its approach to assessing the impact of disruption and its findings and conclusions. The BIA Report should be presented to the Top Management. This report

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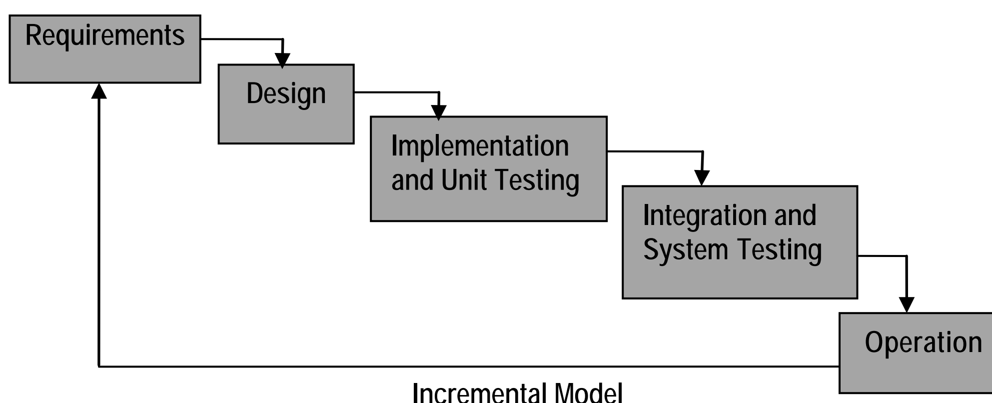
identifies critical service functions and the time frame in which they must be recovered after interruption. The BIA Report should then be used as a basis for identifying systems and resources required to support the critical services provided by information processing and other services and facilities. Developing the Business Continuity Plan (BCP) also takes into account the BIA process.

13. **Incremental Model:** The Incremental Model is a method of software development where the model is designed, implemented and tested incrementally (a little more is added each time) until the product is finished. The product is defined as finished when it satisfies all of its requirements. This model combines the elements of the waterfall model with the iterative philosophy of prototyping. The product is decomposed into a number of components, each of which are designed and built separately. Each component is delivered to the client when it is complete. This allows partial utilization of product and avoids a long development time. It also creates a large initial capital outlay with the subsequent long wait avoided. This model of development also helps to ease the traumatic effect of introducing completely new system all at once. A few pertinent features are listed as follows:

- A series of mini-waterfalls are performed, where all phases of the waterfall development model are completed for a small part of the system, before proceeding to the next increment.
- Overall requirements are defined before proceeding to evolutionary, mini – Waterfall development of individual increments of the system.
- The initial software concept, requirement analysis, and design of architecture and system core are defined using the Waterfall approach, followed by iterative Prototyping, which culminates in installation of the final prototype (i.e. Working system).



Incremental Model

Strengths: Some of the strengths of Incremental Model identified by the experts and practitioners include the following:

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- Potential exists for exploiting knowledge gained in an early increment as later increments are developed.
- Moderate control is maintained over the life of the project through the use of written documentation and the formal review and approval/signoff by the user and information technology management at designated major milestones.
- Stakeholders can be given concrete evidence of project status throughout the life cycle.
- It is more flexible and less costly to change scope and requirements.
- It helps to mitigate integration and architectural risks earlier in the project.
- It allows the delivery of a series of implementations that are gradually more complete and can go into production more quickly as incremental releases.
- Gradual implementation provides the ability to monitor the effect of incremental changes, isolated issues and make adjustments before the organization is negatively impacted.

Weaknesses: Some of the weaknesses of Incremental Model identified by the experts and practitioners include the following:

- When utilizing a series of mini-waterfalls for a small part of the system before moving onto the next increment, there is usually a lack of overall consideration of the business problem and technical requirements for the overall system.
- Each phase of an iteration is rigid and do not overlap each other.
- Problems may arise pertaining to system architecture because not all requirements are gathered up front for the entire software life cycle.
- Since some modules will be completed much earlier than others, well-defined interfaces are required.
- It is difficult to demonstrate early success to management.

14. Some of the prominent System Development Tools are as follows:

(a) **Structured English:** Structured English is the use of the English language with the syntax of structured programming. Thus, Structured English aims at getting the benefits of both the programming logic and natural language. Program logic that helps to attain precision and natural language that helps in getting the convenience of spoken languages. A better structured, universal and precise tool is referred to as pseudo code.

(b) **Flowcharts:** Flowcharting is a pictorial representation technique that can be used by analysts to represent the inputs, outputs and processes of a business process. It is a common type of chart that represents an algorithm or process showing the steps as boxes of various kinds, and their order by connecting these with arrows.

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Flowcharts are used in analyzing, designing, documenting or managing a process or program in various fields.

(c) **Data Flow Diagrams:** A Data Flow Diagram (DFD) uses few simple symbols to illustrate the flow of data among external entities (such as people or organizations, etc.), processing activities and data storage elements. A DFD is composed of four basic elements - Data Sources and Destinations, Data Flows, Transformation processes, and Data stores and have specified symbols.

(d) **Decision Tree:** A Decision Tree is a support tool that uses a tree-like graph or model of decisions and their possible consequences, including chance event outcomes, resource costs, and utility. Decision tree is commonly used in operations research, specifically in decision analysis, to help identify a strategy most likely to reach a goal and to calculate conditional probabilities.

(e) **Decision Table:** A Decision Table is a table, which may accompany a flowchart, defining the possible contingencies that may be considered within the program and the appropriate course of action for each contingency. Decision tables are necessitated by the fact that branches of the flowchart multiply at each diamond (comparison symbol) and may easily run into scores and even hundreds. If, therefore, the programmer attempts to draw a flowchart directly, s/he is liable to miss some of the branches.

(f) **CASE Tools:** CASE (Computer-Aided-Software Engineering) refers to the automation of anything that humans do to develop systems and support virtually all phases of traditional system development process. For example, these packages can be used to create complete and internally consistent requirements specifications with graphic generators and specifications languages. An ideal CASE system would have an integrated set of tools and features to perform all aspects in the life cycle. Some of the features that various CASE products possess are - Repository / Data Dictionary; Computer aided Diagramming Tools; Word Processing; Screen and Report generator; Prototyping; Project Management; Code Generation; and Reverse Engineering.

(g) **System Components Matrix:** A System Component Matrix provides a matrix framework to document the resources used, the activities performed and the information produced by an information system. It can be used as an information system framework for both systems analysis and system design and views the information system as a matrix of components that highlights how the basic activities of input, processing, output, storage and controls are accomplished in an information system; and how the use of hardware, software and people resources can convert data resources into information products.

(h) **Data Dictionary:** A Data Dictionary contains descriptive information about the data items in the files of a business information system. Thus, a data dictionary is a computer file about data. Each computer record of a data dictionary contains

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information about a single data item used in a business information system. This information may include - the identity of the source document(s) used to create the data item; the names of the computer files that store the data item; the names of the computer programs that modify the data item; the identity of the computer programs or individuals permitted to access the data item for the purpose of file maintenance, upkeep, or inquiry; the identity of the computer programs or individuals not permitted to access the data item etc.

(i) **User Interface Layout and Forms:** Several type layout forms for both soft and hard copy are used to model input/output components of an automated information system. Some of the prominent and inevitable ones are Layout form and Screen Generator; Menu Generator; Report Generator and Code Generator.

15. System Maintenance is an important aspect of SDLC. As key personnel change positions in the organization, new changes will be implemented, which will require system updates at regular intervals. Most of the information systems require at least some modification after development. The need for modification arises from a failure to anticipate/capture all the requirements during system analysis/design and/or from changing organizational requirements. Maintenance can be categorized in the following ways:

- **Scheduled Maintenance:** Scheduled maintenance is anticipated and can be planned for operational continuity and avoidance of anticipated risks. For example, the implementation of a new inventory coding scheme can be planned in advance, security checks may be promulgated etc.
- **Rescue Maintenance:** Rescue maintenance refers to previously undetected malfunctions that were not anticipated but require immediate troubleshooting solution. A system that is properly developed and tested should have few occasions of rescue maintenance.
- **Corrective Maintenance:** Corrective maintenance deals with fixing bugs in the code or defects found during the executions. A defect can result from design errors, logic errors coding errors, data processing and system performance errors. The need for corrective maintenance is usually initiated by bug reports drawn up by the end users. Examples of corrective maintenance include correcting a failure to test for all possible conditions or a failure to process the last record in a file.
- **Adaptive Maintenance:** Adaptive maintenance consists of adapting software to changes in the environment, such as the hardware or the operating system. The term environment in this context refers to the totality of all conditions and influences, which act from outside upon the system, for example, business rule, government policies, work patterns, software and hardware operating platforms. The need for adaptive maintenance can only be recognized by monitoring the environment.

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- **Perfective Maintenance:** Perfective maintenance mainly deals with accommodating to the new or changed user requirements and concerns functional enhancements to the system and activities to increase the system's performance or to enhance its user interface.
- **Preventive Maintenance:** Preventive maintenance concerns with the activities aimed at increasing the system's maintainability, such as updating documentation, adding comments, and improving the modular structure of the system. The long-term effect of corrective, adaptive and perfective changes increases the system's complexity. As a large program is continuously changed, its complexity, which reflects deteriorating structure, increases unless work is done to maintain or reduce it. This work is known as preventive change.

16. Audit of Information Systems is required due to following reasons:

- **Organisational Costs of Data Loss:** Data is a critical resource of an organisation for its present and future process and its ability to adapt and survive in a changing environment.
- **Cost of Incorrect Decision Making:** Management and operational controls taken by managers involve detection, investigations and correction of the processes. These high level decisions require accurate data to make quality decision rules.
- **Costs of Computer Abuse:** Unauthorised access to computer systems, malwares, unauthorised physical access to computer facilities and unauthorised copies of sensitive data can lead to destruction of assets (hardware, software, data, information etc.)
- **Value of Computer Hardware, Software and Personnel***:* These are critical resources of an organisation, which has a credible impact on its infrastructure and business competitiveness.
- **High Costs of Computer Error:** In a computerised enterprise environment where many critical business processes are performed, a data error during entry or process would cause great damage.
- **Maintenance of Privacy:** Today, data collected in a business process contains private information about an individual too. These data were also collected before computers but now, there is a fear that privacy has eroded beyond acceptable levels.
- **Controlled evolution of computer Use:** Use of Technology and reliability of complex computer systems cannot be guaranteed and the consequences of using unreliable systems can be destructive.

17. **System Control Audit Review File (SCARF):** The SCARF technique involves embedding audit software modules within a host application system to provide continuous monitoring of the system's transactions. The information collected is written

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onto a special audit file - the SCARF master files. Auditors then examine the information contained on this file to see if some aspect of the application system needs follow-up. In many ways, the SCARF technique is like the snapshot technique along with other data collection capabilities. Auditors might use SCARF to collect the following types of information:

- **Application System Errors** - SCARF audit routines provide an independent check on the quality of system processing, whether there are any design and programming errors as well as errors that could creep into the system when it is modified and maintained.
- **Policy and Procedural Variances** - Organizations have to adhere to the policies, procedures and standards of the organization and the industry to which they belong. SCARF audit routines can be used to check when variations from these policies, procedures and standards have occurred.
- **System Exception** - SCARF can be used to monitor different types of application system exceptions. For example, salespersons might be given some leeway in the prices they charge to customers. SCARF can be used to see how frequently salespersons override the standard price.
- **Statistical Sample** - Some embedded audit routines might be statistical sampling routines, SCARF provides a convenient way of collecting all the sample information together on one file and use analytical review tools thereon.
- **Snapshots and Extended Records** - Snapshots and extended records can be written into the SCARF file and printed when required.
- **Profiling Data** - Auditors can use embedded audit routines to collect data to build profiles of system users. Deviations from these profiles indicate that there may be some errors or irregularities.
- **Performance Measurement** - Auditors can use embedded routines to collect data that is useful for measuring or improving the performance of an application system.

18. Section 10 of IT Amendment Act 2008 discusses the provision of "Power to make rules by Central Government in respect of Electronic Signature" which states that -

The Central Government may, for the purposes of this Act, by rules, prescribe

(a) the type of Electronic Signature;

(b) the manner and format in which the Electronic Signature shall be affixed;

(c) the manner or procedure which facilitates identification of the person affixing the Electronic Signature;

(d) control processes and procedures to ensure adequate integrity, security and confidentiality of electronic records or payments; and

(e) any other matter which is necessary to give legal effect to Electronic Signature.

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19. Mandatory audits of systems and processes bring transparency in the complex workings of Securities and Exchange Board of India (SEBI), prove integrity of the transactions and build confidence among the stakeholders. SEBI has mandated that exchanges shall conduct an annual system audit by a reputed independent auditor. The guidelines recommended by Securities and Exchange Board of India (SEBI) to conduct audit of systems are as follows:

- The Audit shall be conducted according to the Norms, Terms of References (TOR) and Guidelines issued by SEBI.
- Stock Exchange/Depository (Auditee) may negotiate and the board of the Stock Exchange / Depository shall appoint the Auditors based on the prescribed Auditor Selection Norms and TOR. The Auditors can perform a maximum of 3 successive audits. The proposal from Auditor must be submitted to SEBI for records.
- Audit schedule shall be submitted to SEBI at-least 2 months in advance, along with scope of current audit & previous audit.
- The scope of the Audit may be extended by SEBI, considering the changes which have taken place during last year or post previous audit report
- Audit has to be conducted and the Audit report be submitted to the Auditee. The report should have specific compliance/non-compliance issues, observations for minor deviations as well as qualitative comments for scope for improvement. The report should also take previous audit reports in consideration and cover any open items therein.
- The Auditee management provides their comment about the Non-Conformities (NCs) and observations. For each NC, specific time-bound (within 3 months) corrective action must be taken and reported to SEBI. The auditor should indicate if a follow-on audit is required to review the status of NCs. The report along with Management Comments shall be submitted to SEBI within 1 month of completion of the audit. Sample areas of review covered by IS Audit assignments are given here.

20. Emerging threats under "Bring Your Own Device (BYOD)" can be classified into four areas as outlined below:

- **Network Risks:** It is normally exemplified and hidden in 'Lack of Device Visibility'. When company-owned devices are used by all employees within an organization, the organization's Information Technology practice has complete visibility of the devices connected to the network. This helps to analyze traffic and data exchanged over the Internet. As BYOD permits employees to carry their own devices (smart phones, laptops for business use), the IT practice team is unaware about the number of devices being connected to the network. As network visibility is of high importance, this lack of visibility can be hazardous. For example - if a virus hits the network and all the devices connected to the network need be scanned, it is probable that some of the devices would miss out on this routine scan operation. In

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addition to this, the network security lines become blurred when BYOD is implemented.

- **Device Risks:** It is normally exemplified and hidden in 'Loss of Devices'. A lost or stolen device can result in an enormous financial and reputational embarrassment to an organization as the device may hold sensitive corporate information. Data lost from stolen or lost devices ranks as the top security threats as per the rankings released by Cloud Security Alliance. With easy access to company emails as well as corporate intranet, company trade secrets can be easily retrieved from a misplaced device.
- **Application Risks:** It is normally exemplified and hidden in 'Application Viruses and Malware'. With an increase in mobile usage, mobile vulnerabilities have increased concurrently. Organizations are not clear in deciding that 'who is responsible for device security – the organization or the user'.
- **Implementation Risks:** It is normally exemplified and hidden in 'Weak BYOD Policy'. The effective implementation of the BYOD program should not only cover the technical issues mentioned above but also mandate the development of a robust implementation policy. Because corporate knowledge and data are key assets of an organization, the absence of a strong BYOD policy would fail to communicate employee expectations, thereby increasing the chances of device misuse. In addition to this, a weak policy fails to educate the user, thereby increasing vulnerability to the above mentioned threats.

21. (a) **Governance of Enterprise IT (GEIT)** is a sub-set of corporate governance and facilitates implementation of a framework of IS controls within an enterprise as relevant and encompassing all key areas. The primary objectives of GEIT are to analyze and articulate the requirements for the governance of enterprise IT, and to put in place and maintain effective enabling structures, principles, processes and practices, with clarity of responsibilities and authority to achieve the enterprise's mission, goals and objectives. Some of the key benefits of GEIT are as follows:

    - It provides a consistent approach integrated and aligned with the enterprise governance approach.
    - It ensures that IT-related decisions are made in line with the enterprise's strategies and objectives.
    - It ensures that IT-related processes are overseen effectively and transparently.
    - It confirms compliance with legal and regulatory requirements.
    - It ensures that the governance requirements for board members are met.

    (b) Two types of planning languages that are commonly used in DSS are **General-purpose planning languages** and **Special-purpose planning languages**. These are discussed below:

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- **General-purpose planning languages** that allow users to perform many routine tasks, for example; retrieving various data from a database or performing statistical analyses. The languages in most electronic spreadsheets are good examples of general-purpose planning languages. These languages enable user to tackle abroad range of budgeting, forecasting, and other worksheet-oriented problems.
- **Special-purpose planning languages** are more limited in what they can do, but they usually do certain jobs better than the general-purpose planning languages. Some statistical languages, such as SAS (Statistical Analysis System) and SPSS (Statistical Package for the Social Sciences) are examples of special purpose planning languages.

(c) **Objectives and Goals of Business Continuity Planning (BCP):** The primary objective of a Business Continuity Plan is to minimize loss by minimizing the cost associated with disruptions and enable an organization to survive a disaster and to re-establish normal business operations. In order to survive, the organization must assure that critical operations can resume normal processing within a reasonable time frame. The key objective of the contingency plan should be to:

- Provide the safety and well-being of people on the premises at the time of disaster;
- Continue critical business operations;
- Minimize the duration of a serious disruption to operations and resources (both information processing and other resources);
- Minimize immediate damage and losses;
- Establish management succession and emergency powers;
- Facilitate effective co-ordination of recovery tasks;
- Reduce the complexity of the recovery effort; and
- Identify critical lines of business and supporting functions.

The goals of the Business Continuity Plan should be to:

- Identify weaknesses and implement a disaster prevention program;
- minimize the duration of a serious disruption to business operations;
- facilitate effective co-ordination of recovery tasks; and
- reduce the complexity of the recovery effort.

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(d) **Strengths of Agile Model:** Some of the strengths identified by the experts and practitioners include the following:

- Agile methodology has the concept of an adaptive team, which enables to respond to the changing requirements.
- The team does not have to invest time and efforts and finally find that by the time they delivered the product, the requirement of the customer has changed.
- Face to face communication and continuous inputs from customer representative leaves a little space for guesswork.
- The documentation is crisp and to the point to save time.

The end result is generally the high quality software in least possible time duration and satisfied customer.

(e) In System Development Life Cycle (SDLC), some of the roles that an auditor has to perform are following:

- To attend project and steering committee meetings and examine project control documentation and conducting interviews in order to ensure 'what project control standards are to be complied with, (such as a formal systems development process) and determining the extent to which compliance is being achieved;
- To examine system documentation such as functional specifications to arrive at an opinion on controls based on the degree to which the system satisfies the general control objectives that any information system should meet;
- To provide a list of the standard controls, over such operational concerns as response time, CPU usage, and random access space availability that the auditor has used as assessment criteria;
- To rate various phases of SDLC on a rating system scale of 1 to 10 ;
- To give control objectives, directives and in general, validate the opinion expressed by technical experts.
- To provide control considerations that include documented policy and procedures; Established Project team with all infrastructure and facilities; Developers/ IT managers are trained on the procedures; Appropriate approvals are being taken at identified mile-stones; Development is carried over as per standards, functional specifications; Separate test environment for development/ test/ production / test plans; Design norms and naming conventions are as per standards and are adhered to; Business owners testing and approval before system going live; Version control on programs; Source Code is properly secured; Adequate audit trails are provided in system; and Appropriateness of methodologies selected etc.;

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- To determine if the expected benefits of the new system are realized and whether users are satisfied with the new system during post implementation review etc.

22. (a) **Full Backup:** A Full Backup captures all files on the disk or within the folder selected for backup. With a full backup system, every backup generation contains every file in the backup set. However, the amount of time and space such a backup takes, prevents it from being a realistic proposition for backing up a large amount of data.

    Incremental Backup: An Incremental Backup captures files that were created or changed since the last backup, regardless of backup type. This is the most economical method, as only the files that changed since the last backup are backed up. This saves a lot of backup time and space. Normally, incremental backup are very difficult to restore. One will have to start with recovering the last full backup, and then recovering from every incremental backup taken since.

    (b) **Open System:** An Open System interacts with other systems in its environment. For example - Information system is an open system because it takes input from the environment and produces output to the environment, which changes as per the changes in the environment.

    Closed System: Closed System does not interact with the environment and does not change with the changes in environment. Consider a 'throw-away' type sealed digital watch, which is a system, composed of a number of components that work in a cooperative fashion designed to perform some specific task. This watch is a closed system as it is completely isolated from its environment for its operation.

    (c) **Explicit knowledge:** Explicit Knowledge can be formalized easily and as a consequence is easily available across the organization. Explicit knowledge is articulated, and represented as spoken words, written material and compiled data. This type of knowledge is codified, easy to document, transfer and reproduce. For example: Online tutorials, Policy and procedural manuals.

    Tacit knowledge: Tacit Knowledge resides in a few often-in just one person and hasn't been captured by the organization or made available to others. Tacit knowledge is unarticulated and represented as intuition, perspective, beliefs, and values that individuals form based on their experiences. It is personal, experimental and context-specific. It is difficult to document and communicate the tacit knowledge. For example – hand-on skills, special know-how, employee experiences.

    (d) **Quality Assurance Management Control:** It is responsible for ensuring information systems development; implementation, operation, and maintenance conform to established quality standards. Organizations are increasingly producing safety-critical systems and users are becoming more demanding in terms of the

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quality of the software they employ to undertake their work. Organizations are undertaking more ambitious information systems projects that require more stringent quality requirements and are becoming more concerned about their liabilities if they produce and sell defective software.

Security Management Control: It is responsible for access controls and physical security over the information systems function. Information security administrators are responsible for ensuring that information systems assets are secure. Assets are secure when the expected losses that will occur over some time are at an acceptable level. Some of the major threats and to the security of information systems and their controls are Fire, Water, Energy Variations, Structural Damage, Pollution, Unauthorized Intrusion, Viruses and Worms, Misuse of software, data and services, Hackers etc.

(e) **Program Debugging:** Debugging is the most primitive form of testing activity which refers to correcting programming language syntax and diagnostic errors so that the program compiles cleanly. A clean compile means that the program can be successfully converted from the source code written by the programmer into machine language instructions. Debugging can be a tedious task consisting of following four steps - Give input the source program to the compiler; Let the compiler to find errors in the program; Correct lines of code that are erroneous, and Resubmit the corrected source program as input to the compiler.

Program Testing: A careful and thorough testing of each program is imperative to the successful installation of any system. The programmer should plan the testing to be performed, including testing of all the possible exceptions. The test plan should require the execution of all standard processing logic based on chosen testing strategy/techniques. The program test plan should be discussed with the project manager and/or system users. A log of test results and all conditions successfully tested should be kept. The log will prove invaluable in finding the faults and debugging.

23. (a) The final deliverable during the System Requirements Analysis (SRA) phase is Systems Requirements Specification (SRS). The activities to be performed during this phase are as follows:

- To identify and consult the stakeholders to determine their expectations and resolve their conflicts;
- To analyze requirements to detect and correct conflicts and determine their priorities;
- To verify that the requirements are complete, consistent, unambiguous, verifiable, modifiable, testable and traceable;
- To gather data or find facts using tools like interviewing, research/document collection, questionnaires, observation;

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- To model the activities such as developing models to document Data Flow Diagrams, E-R Diagrams; and
- To document activities such as interview, questionnaires, reports etc. and development of a system (data) dictionary to document the modelling activities.

(b) The major Boundary controls of the system are the access control mechanisms. Access controls are implemented with an access control mechanism and links the authentic users to the authorized resources for which they are permitted to access. The access control mechanism has three steps - Identification, Authentication and Authorization with respect to the access control policy.

Major Boundary Control techniques are as follows:

- **Cryptography:** It deals with programs for transforming data into codes that are meaningless to anyone, who does not possess the authentication to access the respective system resource or file. A cryptographic technique encrypts data into cryptograms and its strength depends on the time and cost to decipher the cipher text by a cryptanalyst. The three techniques of cryptography are transposition (permute the order of characters within a set of data), substitution (replace text with a key-text) and product cipher (combination of transposition and substitution).
- **Passwords:** User identification by an authentication mechanism with personal characteristics like name, birth date, employee code, function, designation or a combination of two or more of these can be used as a password boundary access control. A few best practices followed to avoid failures in this control system are - minimum password length, avoid usage of common dictionary words, periodic change of passwords, encryption of passwords and number of entry attempts.
- **Personal Identification Numbers (PIN):** PIN is similar to a password assigned to a user by an institution based on the user characteristics and encrypted using a cryptographic algorithm or the institute generates a random number stored in its database independent to a user identification details, or a customer selected number. Hence, a PIN or a digital signature are exposed to vulnerabilities while issuance or delivery, validation, transmission and storage.
- **Identification Cards:** Identification cards are used to store information required in an authentication process. These cards used to identify a user; are to be controlled through the application for a card, preparation of the card, issue, use and card return or card termination phases.
- **Biometric devices:** Biometric identification e.g. thumb and/or finger impression, eye retina etc. are also used as boundary control techniques.

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24. **(a)** During the automation of various processes of ABC Company, the technical consultant of the company has given the following major suggestions:

- By realizing the importance of information security, he suggested to introduce it right from the beginning.
- In addition, he also suggested performing the risk assessment activity.
- Finally, he advised to mitigate the assessed risk.

For the implementation of all the above mentioned suggestions, the company takes the following steps:

- The company followed various best practices for each process for the proper implementation of the suggestions.
- In addition, the company also tested the compliance of appropriate standards' after each activity, to check the quality of each process.
- Further, the company also implemented the policies related to business continuity planning and disaster recovery to ensure three broad expectations from the software: resist, tolerate and recover.

(b) **Recovery Plan:** The Recovery plans set out procedures to restore full information system capabilities. Recovery plans should identify a recovery committee that will be responsible for working out the specification of the recovery to be undertaken.

The plan should specify the responsibilities of the committee and provide guidelines on priorities to be followed. The plan might also indicate '*which applications are to be recovered first*'. Members of a recovery committee must understand their responsibilities and must periodically review and practice for executing their responsibilities so that they are prepared for a disaster. If committee members leave the organization, new members must be appointed immediately and briefed about their responsibilities.

(c) A good Information Security Policy should clearly state the following:

- Purpose and scope of the document and the intended audience,
- The Security infrastructure,
- Security policy document maintenance and compliance requirements,
- Incident response mechanism and incident reporting,
- Security organization structure,
- Inventory and classification of assets,
- Description of technologies and computing structure,
- Physical and environmental security,
- Identity management and access control,

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- IT operations management,
- IT communications,
- System development and maintenance controls,
- Business Continuity Planning (BCP),
- Legal compliances,
- Monitoring and auditing requirements, and
- Underlying technical policy.

25. **(a)** Conversion from existing information system to a new system involves the following activities:

(i) Defining the procedures for correcting and converting the data into the new application, determining 'what data can be converted through software and what data manually';

(ii) Performing data cleansing before data conversion;

(iii) Identifying the methods to assess the accuracy of conversion like record counts and control totals;

(iv) Designing exception reports showing the data which could not be converted through software; and

(v) Establishing responsibility for verifying and signing off and accepting overall conversion by the system owner.

(b) The different office activities under Office Automation Systems (OAS) are discussed as under:

(i) **Document capture:** Documents originating from outside sources like incoming mails, notes, handouts, charts, graphs etc. need to be preserved.

(ii) **Document Creation:** This consists of preparation of documents, dictation, editing of texts etc. and takes up major part of the secretary's time.

(iii) **Receipts and Distribution:** This basically includes distribution of correspondence to designated recipients.

(iv) **Filling, Search, Retrieval and Follow-up:** This is related to filling, indexing, searching of documents, which takes up significant time.

(v) **Calculations:** These include the usual calculator functions like routine arithmetic, operations for bill passing, interest calculations, working out the percentages and the like.

(vi) **Recording Utilization of Resources:** This includes, where necessary, record keeping in respect of specific resources utilized by office personnel.

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All the activities mentioned have been made very simple and effective by the use of computers. The application of computers to handle the office activities is also termed as office automation.

(c) **Business Continuity Planning (BCP)** is the creation and validation of a practical logistical plan for how an organization will recover and restore partially or completely interrupted critical functions within a predetermined time after a disaster or extended disruption. The logistical plan is called a Business Continuity Plan. Planning is an activity to be performed before the disaster occurs otherwise it would be too late to plan an effective response. The resulting outage from such a disaster can have serious effects on the viability of a firm's operations, profitability, quality of service, and convenience.

Business Continuity covers the following areas:

(i) **Business Resumption Planning:** The Operation's piece of business continuity planning;

(ii) **Disaster Recovery Planning:** The technological aspect of BCP, the advance planning and preparation necessary to minimize losses and ensure continuity of critical business functions of the organization in the event of a disaster.

(iii) **Crisis Management:** The overall co-ordination of an organization's response to a crisis in an effective timely manner, with the goal of avoiding or minimizing damage to the organization's profitability, reputation or ability to operate.

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PAPER – 7 : DIRECT TAX LAWS

PART – III : QUESTIONS AND ANSWERS

QUESTIONS

Basic Concepts

1. "The object for which subsidy/assistance is given by the Government determines the nature of the subsidy – Revenue or Capital". – Discuss the relevance of the rationale of the Supreme Court ruling in *Ponni Sugar Mills'* case in respect of such subsidy received on or after 1.4.2015.

Residential Status and Scope of Total Income

2. Mr. Anand is an Indian citizen and a member of the crew of a Singapore bound Indian ship engaged in carriage of passengers in international traffic departing from Chennai port on 6th June, 2015. From the following details for the P.Y.2015-16, determine the residential status of Mr. Anand for A.Y.2016-17, assuming that his stay in India in the last 4 previous years (preceding P.Y.2015-16) is 400 days and last seven previous years (preceding P.Y.2015-16) is 750 days:

Particulars	Date
Date entered into the Continuous Discharge Certificate in respect of joining the ship by Mr. Anand	6th June, 2015
Date entered into the Continuous Discharge Certificate in respect of signing off the ship by Mr. Anand	9th December, 2015

3. ABC Inc., a Swedish company headquartered at Stockholm, not having a permanent establishment in India, has set up a liaison office in Mumbai in April, 2015 in compliance with RBI guidelines to look after its day to day business operations in India, spread awareness about the company's products and explore further opportunities. The liaison office takes decisions relating to day to day routine operations and performs support functions that are preparatory and auxiliary in nature. The significant management and commercial decisions are, however, in substance made by the Board of Directors at Sweden. Determine the residential status of ABC Inc. for A.Y.2016-17.

Income which do not form part of total income [Charitable Trusts]

4. An institution having yoga as its main object is registered under section 12AA. Its total receipts for the P.Y.2015-16 is ₹ 40 lakhs, out of which receipts from business activity is ₹ 10 lakhs. Discuss whether the institution would continue to retain its "charitable status" and be eligible for exemption under section 11 for A.Y.2016-17, if its registration has not been cancelled.

   Would your answer be different if the above institution has "advancement of any other object of general public utility" as its main object and applies its receipts from business activity towards its main object?

Profits and gains of business or profession

5. Alpha Ltd. set up a manufacturing unit in Vaishali district of Bihar on 1st April, 2015. The company invested ₹ 20 crore in acquisition of new plant and machinery on 3rd May, 2015 and another ₹ 20 crore in acquisition of plant and machinery on 21st December, 2015, out of which ₹ 10 crore was second hand plant and machinery. The new plant and machinery were installed and put to use from the date of acquisition. You are required to calculate the depreciation allowable under section 32.

   Discuss whether Alpha Ltd. would be eligible for any other benefit in respect of such investment in plant and machinery.

   What would be the position if such manufacturing unit is set up by Alpha & Co., a firm, instead of Alpha Ltd.?

6. Discuss, with the aid of case laws, whether the following expenditure would qualify for deduction under section 37 while computing income under the head "Profits and gains of business or profession" –

   (i) Commission paid to doctors by a diagnostic centre for referring patients for diagnosis;

   (ii) Freebies provided by pharmaceutical companies to medical practitioners; and

   (iii) Amount paid by a construction company as regularization fee for compounding an offence for violating building bye-laws

Capital Gains

7. Mrs. Aparna, a resident individual, sold her house property on 16.01.2016. On the said transaction, she earned a long-term capital gain of ₹ 1,91,50,000. She invested a sum of ₹ 35,00,000 in bonds of NHAI on 05.03.2016. She further invested a sum of ₹ 45,00,000 in bonds of RECL on 05.05.2016. She purchased a house property for ₹ 60 lakhs in Malaysia on 15.3.2016. She purchased two flats situated adjacent to each other in Pune on 25.7.2016 through two different sale deeds from two different buyers for ₹ 25 lakhs each and constructed a door to link both the flats so that she can use the same as a single house property. Her other income representing interest on fixed deposits for the financial year 2015-16 was ₹ 32,000. Compute the tax payable by her for the A.Y.2016-17.

Capital Gains & Income from other sources

8. Kashvi purchased a residential house in Meerut from her colleague Bhavna at ₹ 20 lacs on 10th January, 2016. The value determined by the Stamp Valuation Authority for stamp duty purpose amounted to ₹ 25 lakhs. Bhavna had purchased the house on 31st January, 2013 at a cost of ₹ 8 lakhs. Kashvi sold the flat for ₹ 40 lacs on 15th March, 2016.

   Determine the effect of the above transactions on the assessments of Kashvi and Bhavna for assessment year 2016-17, assuming that value for stamp duty purpose in case of the second sale was not more than the sale consideration.

Income of other persons included in assessee's total income

9. (i) Mr. Arnab has gifted a flat valued at ₹ 50 lakhs to his wife, Mrs. Sowmya, who in turn has gifted the same to Mrs. Sahana, their daughter-in-law. The flat was let out at ₹ 30,000 per month throughout the year. Compute the total income of Mr. Arnab and Mrs. Sahana.

   What would be your answer if the said flat was gifted to his son, Mr. Rishabh, who is the husband of Mrs. Sahana?

   (ii) Mr. Vishal gifted a sum of ₹ 9 lakhs to his brother's wife Mrs. Meena on 30.8.2015. On 10.9.2015, his brother, Mr. Vaibhav gifted a sum of ₹ 7 lakhs to Mr. Vishal's wife, Geetha. The gifted amounts were invested as fixed deposits in banks by Mrs. Meena and Mrs. Geetha on 1.10.2015 at 8% interest. Discuss the consequences of the above under the provisions of the Income-tax Act, 1961 in the hands of Mr. Vishal and Mr. Vaibhav.

Set-off and carry forward of losses

10. Mr. Ashwin, carrying on sole proprietary business, died on 31st March, 2015. On his death, the same business was continued by his legal heirs, by forming a firm. As on 31st March 2015, a determined business loss of ₹ 12 lakhs is to be carried forward under the Income-tax Act, 1961.

    Discuss whether the firm consisting of all legal heirs of Mr. Ashwin would get a right to have this business loss adjusted against its business income for A.Y.2016-17.

Deductions from gross total income

11. X Ltd. has commenced the operations of manufacture of goods in a factory on 1.5.2011. It had employed new regular workmen in its factory, the details of whom are as follows –

Previous year	Number of new regular workmen employed during the year	Number of regular workmen leaving employment	Total number of regular workmen as at the end of the Previous year
2011-12	300	-	300
2012-13	300	50	550
2013-14	-	20	530
2014-15	-	30	500

In the P.Y.2015-16, due to capacity addition, it employs the following workmen, including casual workmen and workmen through contract labour, the particulars of whom are given below –

	Nature of workmen	Number employed	Date of employment	Monthly wages paid per workmen (₹)
(i)	Casual workmen	35	20.5.2015	2,000
(ii)	Workmen employed through contract labour	20	20.5.2015	2,500
(iii)	Regular workmen	55	1.5.2015	4,000
		15	31.7.2015	4,000
		10	21.8.2015	4,000

Compute the deduction, if any, under section 80JJAA available to X Ltd. for A.Y.2016-17, if the profits and gains derived from manufacture of goods in the factory for the A.Y.2016-17 is ₹ 8.17 lakhs.

Would deduction under the said section be available, if the details given above pertained to Mr.X instead of X Ltd.?

Inter-relationship between accounting and taxation

12. M/s. XYZ, a partnership firm, was dissolved on 1.4.2015. How is inventory on the date of dissolution of a firm to be valued, where the firm's business is to be continued by Mr.X, one of its partners? What was the manner in which such inventory would have been valued had the dissolution taken place on 31.1.2015 instead of 1.4.2015?

Assessment of various entities

13. L, M and N are investment funds incorporated in India in the form of a limited liability partnership (LLP). For P.Y.2015-16, the following are the particulars relating to the income earned by these funds -

Particulars	L	M	N
	₹		
Business Income		3,00,000	(1,50,000)
Capital Gains	12,00,000	18,00,000	(4,50,000)
Income from Other Sources [Interest on deposits]	6,00,000	7,20,000	9,00,000

(i) Compute the total income of the investment funds and unit-holders for A.Y.2016-17, assuming that:

(1) each investment fund has 30 unit holders each having one unit; and

(2) income from investment in the investment fund is the only income of the unit-holder.

(ii) Determine the amount of loss to be carried forward by Investment Fund N and/or its unit holders to A.Y.2017-18.

(iii) Is distribution tax payable by the Investment Funds on income distributed to unit holders?

(iv) In case the Investment Funds do not distribute the entire income earned during the P.Y.2015-16 to the unit holders by 31.3.2016, would the income chargeable to tax in the hands of unit holders, as computed in (i) above, undergo a change?

14. The following are the details pertaining to M/s. XYZ, a partnership firm, for the year ended 31-3-2016:

    (i) Gross total income of ₹ 420 lakhs, which includes a profit of ₹ 380 lakhs from an undertaking engaged in the business of developing a highway project having a turnover of ₹ 15 crores.

    (ii) The profits of the undertaking are eligible for deduction under section 80-IA. This is the fourth year and the deduction available is ₹ 340 lakhs.

    (iii) The firm has not undertaken any international transaction or specified domestic transaction during the said year.

    Since M/s. XYZ has encountered some issues relating to tax implications of certain transactions in respect of which it wants to seek opinion of tax consultants, it is planning to file the return of income only in the month of December, 2016.

    You are required to work out the total income and tax liability of the firm in both the scenarios - namely, where the return is filed on 30-09-2016 and when the same is filed in December, 2016; and advise the firm the right course of action to minimize tax liability.

Double Taxation Relief

15. Mr. Vikas, an individual resident in India aged 55 years, furnishes you the following particulars of income earned in India, Foreign Countries "A" and "B" for the previous year 2015-16. Compute the total income and tax payable by Mr. Vikas in India for A.Y. 2016-17 assuming that India has not entered into double taxation avoidance agreement with countries A & B.

Particulars	₹
Indian Income:	
Income from business carried on in Mumbai	9,20,000
Interest on savings bank with IDBI Bank	24,000
Income earned in Foreign Country "A" [Rate of tax – 12%]:	
Agricultural income in Country "A"	72,000
Royalty income from a book on art from Country "A" (Gross)	8,00,000
Expenses incurred for earning royalty	70,000
Income earned in Foreign Country "B" [Rate of tax – 23%]:	
Dividend received from a company incorporated in Country "B"	2,25,000

Rent from a house situated in Country "B" (gross)	3,30,000
Municipal tax paid in respect of the above house (not allowed as deduction in Country "B")	10,000

Assessment Procedure

16. The Assessing Officer completed the assessment under section 143(3) on the basis of the returned income filed by Phi Ltd. for a certain assessment year. However, the Assessing Officer initiated reassessment proceeding under section 147 as he had reason to believe that income had escaped assessment on account of certain deductions allowed under section 37 which are not incurred wholly and exclusively for the purpose of business and accordingly, he issued notice under section 148. However, after sufficient enquiries made by him, he came to the conclusion that no additions were required on account of these expenses, since such expenses were ultimately found to be incurred wholly and exclusively for the purpose of the business of Phi Ltd. However, the Assessing Officer made additions on account of disallowances under section 40A(2) in respect of other expenses which were not the original "reason to believe" and passed his reassessment order under section 147. The Assessing Officer is of the view that *Explanation 3* to section 147 permits him to assess the income which has escaped assessment and which comes to his notice subsequently in the course of proceeding under section 147, even though the said issues were not part of the reasons recorded in the notice under section 148. Is the action of the Assessing Officer valid, considering the facts of this case?

Appeals and Revision

17. Discuss, with the aid of decided case laws, the correctness or otherwise of the following statements –
    (i) An assessee can make a fresh claim (i.e., a claim not made in the return of income) before an appellate authority only by filing a revised return of income;
    (ii) The Appellate Tribunal has the power to re-appreciate the correctness of its earlier decision under section 254(2);
18. What are the circumstances when an order passed by the Assessing Officer shall be deemed to be erroneous in so far as it is prejudicial to the interests of the revenue, enabling the Commissioner to exercise revisionary jurisdiction under section 263(1)?

Penalties

19. PQR Ltd., engaged in the specified business of setting up and operating a warehousing facility for storage of food grains, filed its return of income for A.Y.2013-14 on 28th September, 2013. In the return of income of the earlier year i.e., A.Y.2012-13, PQR Ltd. had claimed deduction@100% of cost of ₹ 8 lakhs incurred on purchase of the first building on 1.1.2012 for operating the warehousing facility. In computing its business

income for A.Y.2013-14, it had claimed a weighted deduction@150% of the cost of ₹ 10 lakhs incurred on purchase of the second building on 1.4.2012 for operating the warehousing facility under section 35AD. PQR Ltd. had commenced operations on 1.1.2012, whereas the benefit of weighted deduction@150% was available only where the business was commenced on or after 1.4.2012. The company was under the impression that since the new building was purchased on 1.4.2012, it was eligible for weighted deduction@150% under section 35AD. The Assessing Officer, disallowed ₹ 5 lakhs, being the excess 50% of cost of the second building which was claimed as weighted deduction under section 35AD, since the same was only eligible for deduction@100%. He also levied penalty under section 271(1)(c). PQR Ltd. agreed with the disallowance made but contended that there no concealment of particulars of income so as to attract penalty under section 271(1)(c), since it had furnished all the details correctly in its return of income and no information given by the company was found to be incorrect or erroneous or false. Discuss the correctness of PQR Ltd.'s contention.

Provisions for deduction and collection of tax at source

20. Discuss the correctness or otherwise of the following statements –

(i) All co-operative banks are exempted from the requirement to deduct tax at source on interest on time deposits credited/paid to its members.

(ii) Interest on recurring deposits are not subject to tax deduction at source.

SUGGESTED ANSWERS/HINTS

1. The Supreme Court in, ***CIT v Ponni Sugar Mills (2008) 306 ITR 392***, observed that it is the object for which the subsidy/assistance is given which determines the nature of the incentive subsidy. If the object of the subsidy scheme was to enable the assessee to run the business more profitably then the receipt is on revenue account. On the other hand, if the object of the assistance under the subsidy scheme was to enable the assessee to set up a new unit or to expand the existing unit then the receipt of the subsidy was on capital account. The rationale of the Supreme Court ruling has been applied in many cases and accordingly, grants given with a view to develop backward area or to enable industries to trade over financial crisis or to generation of employment in a State have been regarded as being capital in nature. For instance, in ***CIT v. Rasoi Ltd. (2011) 335 ITR 438 (Cal.)***, it was held that subsidy received by the assessee from the Government of West Bengal under the scheme of industrial promotion for expansion of its capacities, modernization and improving its marketing capabilities was a capital receipt, not chargeable to tax. In ***CIT v. Kisan Sahkari Chini Mills Ltd. (2010) 328 ITR 27 (All.)***, it was held that incentive received under the scheme formulated by the Central Government for recoupment of capital employed and repayment of loans taken for setting up/expansion of a sugar factory was a capital receipt.

However, with effect from A.Y.2016-17, government grants have been specifically included in the definition of income under section 2(24) and the taxability of such grants would be governed by ICDS VII on Government Grants.

The Central Government has[1], in exercise of the powers conferred under section 145(2), notified ten income computation and disclosure standards (ICDSs) to be followed by all assessees, following the mercantile system of accounting, for the purposes of computation of income chargeable to income-tax under the head "Profit and gains of business or profession" or "Income from other sources". This notification has come into force with effect from 1st April, 2015, and shall accordingly apply to the A.Y. 2016-17 and subsequent assessment years.

ICDS VII deals with the treatment of government grants. As per this ICDS, except in case of government grant relating to a depreciable fixed asset, which has to be reduced from written down value or actual cost, all other grants have to be recognized as upfront income or as income over the periods necessary to match them with the related costs which they are intended to compensate.

Further, in line with the requirement in ICDS VII, sub-clause (xviii) has been included in the definition of income under section 2(24). Accordingly, assistance in the form of a subsidy or grant or cash incentive or duty drawback or waiver or concession or reimbursement, by whatever name called, by the Central Government or a State Government or any authority or body or agency in cash or kind to the assessee is included in the definition of income. The only exclusion is the subsidy or grant or reimbursement which has been taken into account for determination of the actual cost of the asset in accordance with *Explanation 10* to section 43(1).

Thus, the rationale of the Supreme Court ruling in *Ponni Sugar Mills*' case that the object for which the Government subsidy was given would determine the nature of the subsidy is not relevant in respect of subsidy received on or after 1.4.2015, consequent to amendment of section 2(24) and notification of ICDS VII on Government Grants with effect from A.Y.2016-17.

2. As per section 6, an individual is treated as resident if he has stayed for 182 days in India during the previous year or if he has stayed for 60 days in the current previous year and 365 days in total during the four preceding previous years. However, where an Indian citizen leaves India as a member of crew of an Indian ship or for the purpose of employment outside India, he will be resident only if he stayed for 182 days during the previous year.

Explanation 2 has been inserted by the Finance Act, 2015 in section 6(1) to provide that in the case of an Individual, being a citizen of India and a member of the crew of a foreign

[1] *vide* Notification No. 32/2015 dated 31.3.2015

bound ship leaving India, the period or periods of stay in India shall, in respect of such voyage, be determined in the prescribed manner and subject to the prescribed conditions.

Accordingly, the CBDT has prescribed the manner of determination of period of stay. For the purposes of section 6(1), in case of an individual, being a citizen of India and a member of the crew of a ship, the period or periods of stay in India shall, in respect of an eligible voyage, not include the period beginning on the date entered into the Continuous Discharge Certificate in respect of joining the ship by the said individual for the eligible voyage and ending on the date entered into the Continuous Discharge Certificate in respect of signing off by that individual from the ship in respect of such voyage.

Eligible voyage refers to a voyage undertaken by a ship engaged in the carriage of passengers or freight in international traffic where –

(i) for the voyage having originated from any port in India, has as its destination any port outside India; and

(ii) for the voyage having originated from any port outside India, has as its destination any port in India.

In this case, the voyage is undertaken by an Indian ship engaged in the carriage of passengers in international traffic, originating from a port in India (i.e., the Chennai port) and having its destination at a port outside India (i.e., the Singapore port). Hence, the voyage is an eligible voyage for the purposes of section 6(1). Therefore, the period beginning from 6th June, 2015 and ending on 9th December, 2015, being the dates entered into the Continuous Discharge Certificate in respect of joining the ship and signing off from the ship by Mr. Anand, an Indian citizen who is a member of the crew of the ship, has to be excluded for computing the period of his stay in India. Accordingly, 187 days [25+31+31+30+31+30+9] have to be excluded from the period of his stay in India. Consequently, Mr. Anand's period of stay in India during the P.Y.2015-16 would be 179 days [i.e., 366 days – 187 days]. Since his period of stay in India during the P.Y.2015-16 is less than 182 days, he is a non-resident for A.Y.2016-17.

Note *- Since the residential status of Mr. Anand is "non-resident" for A.Y.2016-17 consequent to his number of days of stay in P.Y.2015-16 being less than 182 days, his period of stay in the earlier previous years become irrelevant.*

3. Section 6(3) has been substituted by the Finance Act, 2015 with effect from A.Y.2016-17 to provide that a company would be resident in India in any previous year, if-

(i) it is an Indian company; or

(ii) its place of effective management, in that year, is in India .

In this case, ABC Inc. is a foreign company. Therefore, it would be resident in India for P.Y.2015-16 only if its place of effective management, in that year, is in India.

Explanation to section 6(3) defines "place of effective management" to mean a place where key management and commercial decisions that are necessary for the conduct of the

business of an entity as a whole are, in substance made. In the case of ABC Inc., its place of effective management for P.Y.2015-16 is not in India, since the significant management and commercial decisions are, in substance, made by the Board of Directors outside India in Sweden.

ABC Inc. has only a liaison office in India through which it looks after its routine day to day business operations in India. The place where decisions relating to day to day routine operations are taken and support functions that are preparatory or auxiliary in nature are performed are not relevant in determining the place of effective management.

Hence, ABC Inc., being a foreign company is a non-resident for A.Y.2016-17, since its place of effective management is outside India in the P.Y.2015-16.

4. Section 2(15) defines "charitable purpose" to include relief of the poor, education, ***yoga***, medical relief, preservation of environment (including watersheds, forests and wildlife) and preservation of monuments or places or objects of artistic or historic interest and the advancement of any other object of general public utility. However, the "advancement of any other object of general public utility" shall not be a charitable purpose, if the institution is carrying on any activity in the nature of trade, commerce or business, or any activity of rendering any service in relation to any trade, commerce or business, for a cess or fee or any other consideration, irrespective of the nature of use or application, or retention, of the income derived from such activity.

Since ***yoga*** has been specifically included in the definition of "charitable purpose" by the Finance Act, 2015 with effect from A.Y.2016-17, it would no longer fall under the residual clause "advancement of any other object of general public utility". Therefore, an institution having yoga as its main object would not be subject to the restrictions which are applicable to the "advancement of any other object of general public utility". Such institution would continue to retain its "charitable" status, even if it derives income from an activity in the nature of trade.

However, if an institution having its main object as "advancement of any other object of general public utility", derives income from an activity in the nature of trade during a financial year, it would lose its "charitable" status for that year, even if it applies such income for its main objects.

It may be noted that if the receipts from such activity does not exceed 20% of the total receipts in that year, then, the institution would not lose its "charitable" status, even its main object is "advancement of any other object of general public utility", provided such activity is undertaken in the course of actual carrying out of such advancement of any other object of general public utility.

In this case, the receipts from such activity are 25% of total receipts. Hence, the institution will lose its charitable status and will not get the benefit of tax exemption under section 11 or 12 in the P.Y.2015-16, even if it applies such receipts for its main object and irrespective of whether the registration issued is cancelled or not.

5. (i) **Computation of depreciation under section 32 for Alpha Ltd. for A.Y. 2016-17**

Particulars		₹ (in crores)
Plant and machinery acquired on 03.05.2015		20.00
Plant and machinery acquired on 21.12.2015		20.00
WDV as on 31.03.2016		**40.00**
Less: Depreciation @ 15% on ₹ 20 crore	3.00	
Depreciation @ 7.5% (50% of 15%) on ₹ 20 crore	1.50	
Additional Depreciation@35% on ₹ 20 crore	7.00	
Additional Depreciation@17.5% (50% of 35%) on ₹ 10 crore	1.75	13.25
WDV as on 01.04.2016		**26.75**

Alpha Ltd. would also be eligible for benefit of deduction under sections 32AC and 32AD.

Computation of deduction under section 32AC & 32AD for Alpha Ltd. for A.Y. 2016-17

Particulars	₹ (in crores)
Deduction under section 32AC(1A) @ 15% on ₹ 30 crore (since investment in new plant and machinery acquired and installed in the previous year 2015-16 by Alpha Ltd., a manufacturing company, exceeds ₹ 25 crore)	4.50
Deduction under section 32AD @ 15% on ₹ 30 crore (since the manufacturing unit is set up in a notified backward area in the State of Bihar)	4.50
Total benefit	**9.00**

(ii) Yes, the answer would be different, where the manufacturing unit is set up by a firm. The deduction under section 32AC is available only to corporate assessees, and therefore, the deduction of ₹ 4.50 crore under section 32AC would not be available if the manufacturing unit is set up by Alpha & Co., a firm. However, the firm would be eligible for deduction of ₹ 4.50 crore under section 32AD.

Notes:

(1) As per the second proviso to section 32(1)(ii), where an asset acquired during the previous year is put to use for less than 180 days in that previous year, the amount of deduction allowable as normal depreciation and additional depreciation would be restricted to 50% of amount computed in accordance with the prescribed percentage.

Therefore, normal depreciation on plant and machinery acquired and put to use on 21st December, 2015 is restricted to 7.5% (being 50% of 15%) and additional depreciation is restricted to 17.5% (being 50% of 35%).

(2) As per third proviso to section 32(1)(ii), the balance additional depreciation of ₹ 1.75 crore, being 50% of ₹ 3.50 crore (35% of ₹ 10 crore) would be allowed as deduction in the A.Y.2017-18.

(3) As per section 32(1)(iia), additional depreciation is allowable in the case of any new machinery or plant acquired and installed after 31.3.2005 by an assessee engaged, *inter alia*, in the business of manufacture or production of any article or thing. In this case, since new plant and machinery acquired was installed by a manufacturing unit set up in a notified backward area in the State of Bihar, the rate of additional depreciation is 35% of actual cost of new plant and machinery. Since new plant and machinery of ₹ 10 crore was put to use for less than 180 days, additional depreciation@17.5% (50% of 35%) is allowable as deduction. However, additional depreciation shall not be allowed in respect of second hand plant and machinery of ₹ 10 crore.

Likewise, the benefit available under sections 32AC and 32AD would not be allowed in respect of second hand plant and machinery.

Accordingly, additional depreciation and deduction under sections 32AC and 32AD have not been provided on ₹ 10 crore, being the actual cost of second hand plant and machinery acquired and installed in the previous year.

6. **(i) No; the expenditure is not allowable as deduction under section 37.**

The Punjab & Haryana High Court, in *CIT v. Kap Scan and Diagnostic Centre P. Ltd. (2012) 344 ITR 476*, observed that as per the Indian Medical Council (Professional Conduct, Etiquette and Ethics) Regulations, 2002, no physician shall give, solicit, receive, or offer to give, solicit or receive, any gift, gratuity, commission or bonus in consideration of a return for referring any patient for medical treatment.

The demanding as well as paying of such commission is bad in law. It is not a fair practice and is opposed to public policy. Applying the rationale and considering the purpose of *Explanation* to section 37(1), the assessee would not be entitled to deduction of payments made in contravention of law. Similarly, payments which are opposed to public policy being in the nature of unlawful consideration cannot also be claimed as deduction. Thus, the High Court held that commission paid to doctors for referring patients for diagnosis is not allowable as a business expenditure

(ii) No; the expenditure is not allowable as deduction under section 37.

The Himachal Pradesh High Court in, *Confederation of Indian Pharmaceutical Industry (SSI) v. CBDT (2013) 353 ITR 388*, observed that as per Indian Medical Council (Professional Conduct, Etiquette and Ethics) Regulations, 2002, every medical practitioner and his or her professional associate is prohibited from accepting any gift, travel facility, hospitality, cash or monetary grant from any

pharmaceutical and allied health sector industries. This is a salutary regulation in the interest of the patients and the public, considering the increase in complaints against the medical practitioners prescribing branded medicines instead of generic medicines, solely in lieu of gifts and other freebies granted to them by some particular pharmaceutical industries.

The Court also observed that CBDT, considering the fact that the claim of any expense incurred in providing freebies to medical practitioners is in violation of the provisions of Indian Medical Council (Professional Conduct, Etiquette and Ethics) Regulations, 2002, has, *vide Circular No.5/2012 dated 1.8.2012*, clarified that the expenditure so incurred shall be inadmissible under section 37(1). The disallowance shall be made in the hands of such pharmaceutical company which has provided aforesaid freebies and claimed it as a deductible expense in its accounts against income.

Note: *The Court, however, observed that if the assessee satisfies the assessing authority that the expenditure incurred is not in violation of the regulations framed by the Medical Council then it may legitimately claim a deduction, but it is for the assessee to satisfy the Assessing Officer that the expense is not in violation of the Medical Council Regulations.*

(iii) No; the expenditure is not allowable as deduction under section 37.

The Karnataka High Court in, *Millennia Developers (P) Ltd. v. DCIT (2010) 322 ITR 401,* held that the amount paid by way of regularisation fee to compound an offence for deviations made while constructing a structure and for violating the plan sanctioned in terms of approved building bye laws is in the nature of penalty, and hence does not qualify for deduction under section 37. Merely describing the payment as a regularisation fee or compounding fee would not alter the character of the payment.

7. Computation of total income of Mrs. Aparna for the A.Y.2016-17

	Particulars	₹
A	Long term capital gains	1,91,50,000
	Less: Deduction under section 54 **[See Note 1 below]**	50,00,000
		1,41,50,000
	Less: Deduction under section 54EC **[See Notes 2 & 3 below]**	50,00,000
	Long term capital gain	91,50,000
B	Income from Other Sources [Interest on fixed deposit]	32,000
	Total Income	**91,82,000**

As per section 112, in case of an individual, being a resident where her total income includes long-term capital gain and other income, the tax payable on the total income is the aggregate of the amount of income tax on long-term capital gains@ 20% and the amount of income tax on the total income as reduced by the amount of long term capital gain, had the total income so reduced been her total income.

However, the unexhausted basic exemption limit can be exhausted against long-term capital gains, and tax would be leviable on the balance long-term capital gains @ 20%. Therefore, the basic exemption limit of ₹ 2,50,000 should be first adjusted against other income of ₹ 32,000 and the unexhausted basic exemption limit of ₹ 2,18,000 should be adjusted against the long-term capital gains of ₹ 91,50,000. The balance long-term capital gains of ₹ 89,32,000 would be taxable@20% plus education cess@2% and secondary and higher education cess@1%. Therefore, the tax payable by the assessee would be ₹ 18,39,992.

Notes:

(1) Section 54 provides that exemption thereunder can be availed in respect of investment made in **one residential house situated in India**. Therefore, Mrs. Aparna cannot avail exemption under section 54 in respect of investment in house property situated outside India at Malaysia. .

The next issue is whether Mrs. Aparna can claim exemption under section 54 in respect of ₹ 50 lakhs invested in two flats situated next to each other in Pune, where necessary modification has been effected to use the same as a single house. On this issue, the Karnataka High Court in *CIT v. D. Ananda Basappa (2009) 309 ITR 329* observed that where the assessee had shown that the flats were situated side by side and the builder had also certified that he had effected modification of the flats to make them as a single house by constructing a door between the apartments, it was immaterial that the flats were purchased through different sale deeds from two different buyers. The Court observed that these were not the grounds to hold that the assessee did not have the intention to purchase the two flats to be used as one house. The Court held that the assessee was entitled to exemption under section 54 in respect of purchase of both the flats to form one residential house.

Therefore, in this case, Mrs. Aparna can avail exemption in respect of investment of ₹ 50 lakhs in purchase of two flats situated next to each other in Pune, since necessary modification has been effected to use the two flats as a single house property. Also, she has made the investment in purchase of two flats within the stipulated period of two years after the date of transfer.

(2) In order to claim exemption under section 54EC, the assessee has to invest in specified bonds of RECL or NHAI within a period of 6 months from the date of transfer of the asset.

(3) However, investments in such bonds by an assessee during any financial year cannot exceed ₹ 50 lakhs.

Further, second proviso to section 54EC(1) also provides that the investment made by an assessee in bonds of NHAI/RECL, out of capital gains arising from transfer of one or more original assets, during the financial year in which the original asset or assets are transferred and in the subsequent financial year should not exceed ₹ 50 lakhs.

In this case, Mrs. Aparna has invested ₹ 35 lakhs in bonds of NHAI in the F.Y.2015-16 and ₹ 45 lakhs in bonds of RECL in the F.Y.2016-17, both within six months from the date of transfer. However, since the amount of investment made during the financial year in which asset transferred and in the subsequent financial year cannot exceed ₹ 50 lakhs, she is eligible to claim exemption of only ₹ 50 lakhs under section 54EC.

8. **Tax treatment in the hands of the seller, Ms. Bhavna**

Section 50C provides that where the consideration received or accruing as a result of transfer of a capital asset, being land or building or both, is less than the value adopted or assessed or assessable by an authority of a State Government for the purpose of payment of stamp duty in respect of such transfer, the value so adopted or assessed or assessable shall be deemed to be the full value of the consideration received or accruing as a result of such transfer for computing capital gain.

In the instant case, Ms. Bhavna sold the residential house in Meerut to her colleague Ms. Kashvi for ₹ 20 lacs, whereas the stamp duty value was ₹ 25 lacs. Therefore, stamp duty value shall be deemed to be the full value of consideration for sale of the property. Therefore, short-term capital gain arising to Ms. Bhavna for assessment year 2016-17 will be ₹ 17 lacs (i.e. ₹ 25 lacs - ₹ 8 lacs). The gain is a short-term capital gain since the residential house was held by her for a period of less than 36 months immediately preceding the date of transfer.

Tax treatment in the hands of the buyer, Ms. Kashvi

The taxability provisions under section 56(2)(vii) includes within its scope, any immovable property, being land or building or both, received for inadequate consideration by an individual or HUF.

As per section 56(2)(vii), where any immovable property is received for a consideration which is less than the stamp duty by an amount exceeding ₹ 50,000, the difference between the stamp duty value and the consideration shall be chargeable to tax in the hands of the recipient (Individual/HUF) as the income from other sources. The provisions of section 56(2)(vii) would be attracted in this case, since the difference exceeds ₹ 50,000. Therefore, ₹ 5 lacs, being the difference between the stamp duty value of the property (i.e., ₹ 25 lacs) and the actual consideration (i.e., ₹ 20 lacs) would be taxable in the hands of Ms. Kashvi, under the head 'Income from Other Sources'.

As per section 49(4), the cost of acquisition of such property for computing capital gains would be the value which has been taken into account for section 56(2)(vii). Accordingly ₹ 25 lacs would be taken as the cost of acquisition of the residential house. Therefore, on sale of the residential house by Ms. Kashvi, ₹ 15 lacs (i.e. ₹ 40 lacs – ₹ 25 lacs) would be chargeable to tax as short-term capital gain in her hands for A.Y. 2016-17.

9. **(i)** As per section 27(i), an individual who transfers otherwise than for adequate consideration any house property to his spouse, not being a transfer in connection with an agreement to live apart, shall be deemed to be the owner of the house

property so transferred.

Therefore, in this case, Mr. Arnab would be the deemed owner of the flat transferred to his wife Mrs. Sowmya without consideration.

As per section 64(1)(vi), income arising to the son's wife from assets transferred, directly or indirectly, to her by an individual otherwise than for adequate consideration would be included in the total income of such individual.

Income from let-out flat is ₹ 2,52,000 [i.e., ₹ 3,60,000, being the actual rent calculated at ₹ 30,000 per month *less* ₹ 1,08,000, being deduction under section 24@30% of ₹ 3,60,000]

In this case, income of ₹ 2,52,000 from let-out flat arising to Mrs. Sahana, being Mr. Arnab's son's wife, would be included in the income of Mr. Arnab, applying the provisions of section 27(i) and section 64(1)(vi). Such income would, therefore, not be taxable in the hands of Mrs. Sahana.

In case the flat was gifted to Mr. Arnab's son, Mr. Rishabh, the clubbing provisions under section 64 would **not** apply, since Mr. Rishabh is not a minor child. Therefore, the income of ₹ 2,52,000 from letting out of flat gifted to his son, Mr. Rishabh, would be taxable in Mr. Rishabh's hands.

It may be noted that the provisions of section 56(2)(vii) would not be attracted in the hands of the recipient of flat, since the receipt of property in each case was from a "relative" of such individual. Therefore, the stamp duty value of flat would not be chargeable to tax in the hands of the recipient of immovable property, even though the flat was received by her or him without consideration.

***Note** - The question can also be answered by applying the provisions of section 64(1)(vi) directly to include the income of ₹ 2,52,000 arising to Mrs. Sahana in the hands of Mr. Arnab [without first applying the provisions of section 27(i) to deem Mr. Arnab as the owner of the flat transferred to his wife Mrs. Sowmya without consideration], since section 64(1)(vi) speaks of clubbing of income arising to son's wife from indirect transfer of assets to her by her husband's parent, without consideration. Gift of flat by Mr. Arnab to Mrs. Sahana, via Mrs. Sowmya, can be viewed as an indirect transfer by Mr. Arnab to Mrs. Sahana.*

(ii) In this case, Mr. Vishal gifted a sum of ₹ 9 lakhs to his brother's wife Mrs. Meena on 30.8.2015 and simultaneously, his brother, Mr. Vaibhav gifted a sum of ₹ 7 lakhs to Mr. Vishal's wife, Geetha, on 10.09.2015. The gifted amounts were invested as fixed deposits in banks by Mrs. Meena and Mrs. Geetha. These transfers are in the nature of cross transfers. Accordingly, the income from the assets transferred would be assessed in the hands of the deemed transferor because the transfers are so intimately connected to form part of a single transaction and each transfer constitutes consideration for the other by being mutual or otherwise.

If two transactions are inter-connected and are part of the same transaction in such a way that it can be said that the circuitous method was adopted as a device to

evade tax, the implication of clubbing provisions would be attracted. It was so held by the Apex Court in *CIT vs. Keshavji Morarji (1967) 66 ITR 142*.

Accordingly, the interest income arising to Vishal's wife, Geetha, in the form of interest on fixed deposits would be included in the total income of Mr. Vishal and interest income arising in the hands of his brother Vaibhav's wife, Meena, would be taxable in the hands of Mr. Vaibhav as per section 64(1), to the extent of amount of cross transfers i.e., ₹ 7 lakhs.

This is because both Mr. Vishal and his brother, Mr. Vaibhav are the indirect transferors of the income to their respective spouses with an intention to reduce their burden of taxation.

However, the interest income earned by Mrs. Meena on fixed deposit of ₹ 7 lakhs alone would be included in the hands of Mr. Vaibhav and not the interest income on the entire fixed deposit of ₹ 9 lakhs, since the cross transfer is only to the extent of ₹ 7 lakhs.

10. Section 78(2) provides that where a person carrying on any business or profession has been succeeded in such capacity by another person, otherwise than by inheritance, then, the successor is not entitled to carry forward and set-off the loss of the predecessor against his income. This implies that generally, set-off of business losses should be claimed by the same person who suffered the loss and the only exception to this provision is when the business passes on to another person by inheritance.

The facts of the case given in the question are similar to the case *CIT v. Madhukant M. Mehta (2001) 247 ITR 805*, where the Supreme Court has held that if the business is succeeded by inheritance, the legal heirs are entitled to the benefit of carry forward of the loss of the predecessor. Even if the legal heirs constitute themselves as a partnership firm, the benefit of carry forward and set off of the loss of the predecessor would be available to the firm.

In this case, the business of Mr. Ashwin was continued by his legal heirs after his death by constituting a firm. Hence, the exception contained in section 78(2) along with the decision of the Apex Court discussed above, would apply in this case. Therefore, the firm is entitled to carry forward the business loss of ₹ 12 lakhs of Mr. Ashwin for set-off against its business income of A.Y.2016-17.

11. (i) Deduction under section 80JJAA is available where the gross total income of an assessee includes any profits and gains derived from manufacture of goods in a factory and the assessee has employed new regular workmen in such factory in the previous year. The deduction shall be 30% of additional wages (i.e., wages paid to new regular workmen in excess of 50 workmen employed by the assessee in such factory during the previous year). However, in case of an existing factory, no deduction shall be allowed if the increase in the number of regular workmen employed during the year is less than 10% of the existing number of workmen employed in such factory as on the last day of the preceding year.

It may be noted that the deduction under section 80JJAA would be allowable for three assessment years including the assessment year relevant to the previous year in which such employment is provided.

In this case, X Ltd. is eligible for deduction under section 80JJAA for A.Y.2016-17 since its gross total income includes profits and gains derived from the manufacture of goods in a factory and it has employed new regular workmen in its factory in the P.Y.2015-16 in excess of 10% of existing number of workmen as on 31.3.2015.

New regular workmen employed during the P.Y.2015-16 = 55 **[See Working Note below]**

Existing workmen as on 31.3.2015 = 500

New regular workmen is in excess of 10% of existing workmen as on 31.3.2015.

The deduction under section 80JJAA would be 30% of additional wages paid to the new regular workmen employed by it in such factory during the previous year.

Additional wages = ₹ 4,000 per month ×11 months × 55 workmen = ₹ 24,20,000

Deduction under section 80JJAA = 30% of ₹ 24,20,000 = ₹ 7,26,000.

Working Note:

Number of new regular workmen

Particulars	No. of workmen	
Total number of workmen employed during the year		135
Less: Casual workmen employed during the year	35	
Workmen employed through contract labour	20	
Workmen employed for a period of less than 300 days during the P.Y.2015-16 (workmen employed on 31.7.2015 and 21.8.2015)	25	80
Total number of new regular workmen employed during the P.Y.2015-16		55

"Regular workman" does not include a casual workman or a workman employed through contract labour or any other workman employed for a period of less than 300 days during the previous year.

Note – *In respect of new regular workmen employed in the P.Y.2011-12, deduction under section 80JJAA would have been allowed for three assessment years i.e., A.Y.2012-13 to A.Y.2014-15. Likewise, in respect of new regular workmen employed in the P.Y.2012-13, deduction under section 80JJAA would have been allowed for three assessment years i.e., A.Y.2013-14 to A.Y.2015-16.*

(ii) From A.Y.2016-17, deduction under section 80JJAA is not restricted to Indian companies alone. It would be available to any assessee satisfying the conditions mentioned in the said section. Therefore, Mr. X would be entitled to deduction under section 80JJAA for A.Y.2016-17, since he satisfies the conditions mentioned thereunder.

12. Under section 145(1), income chargeable under the heads "Profits and gains of business or profession" or "Income from other sources" shall be computed in accordance with either the cash or mercantile system of accounting regularly employed by the assessee. Section 145(2) empowers the Central Government to notify in the Official Gazette from time to time, income computation and disclosure standards to be followed by any class of assessees or in respect of any class of income. Accordingly, the Central Government has, in exercise of the powers conferred under section 145(2), notified ten income computation and disclosure standards (ICDSs) to be followed by all assessees, following the mercantile system of accounting, for the purposes of computation of income chargeable to income-tax under the head "Profit and gains of business or profession" or "Income from other sources". This notification shall come into force with effect from 1st April, 2015, and shall accordingly apply to the A.Y.2016-17 and subsequent assessment years.

In case of dissolution of a partnership firm or association of persons or body of individuals, Paragraph 24 of ICDS II on Valuation of Inventories requires the inventory on the date of dissolution to be valued at the net realisable value, notwithstanding whether business is discontinued or not.

Accordingly, where the firm M/s. XYZ is dissolved on 1.4.2015, inventory has to be valued at net realizable value, even if the firm's business is continued by partner X.

This requirement in ICDS II is, however, in deviation from the Supreme Court ruling in *Shakti Trading Co. vs. CIT (2001) 250 ITR 871,* where it was held that if the firm is dissolved due to death of a partner and the surviving partners reconstitute the firm and continue the business as before, the firm is entitled to adopt cost or market price, whichever is lower.

Therefore, if the firm M/s.XYZ was dissolved on 31.1.2015, being a date prior to 1.4.2015, when ICDSs became effective, the valuation of inventory would be governed by the Supreme Court ruling in *Shakti Trading Company*'s case and the same has to be valued at the lower of cost or net realizable value. However, if the dissolution takes place on 1.4.2015, it would be governed by ICDS II and the inventory has to be valued at the net realizable value, notwithstanding whether business is discontinued or not.

13. (i) Computation of total income of the investment funds for A.Y.2016-17

Particulars	L	M	N
	₹		
Business Income	Nil	3,00,000	Nil
Capital Gains [Exempt under section 10(23FBA)]	-	-	-
Income from other sources [Exempt under section 10(23FBA)]	-	-	-
Total Income	**Nil**	**3,00,000**[2]	**Nil**

[2] The total income of Investment Fund M would be chargeable to tax@30% since the fund is a LLP.

Computation of total income of a unit holder of the investment funds for A.Y.2016-17

Particulars	L	M	N
	₹		
Business Income [Exempt under section 10(23FBB)]	-	-	-
Capital Gains [₹ 12,00,000/30, ₹ 18,00,000/30, Nil]	40,000	60,000	-
Income from other sources [₹ 6,00,000/30, ₹ 7,20,000/30, (₹ 9,00,000 - ₹ 1,50,000)/30]	20,000	24,000	25,000
Total Income	**60,000**	**84,000**	**25,000**

Notes:

(1) As per section 10(23FBA), income other than profits and gains of business or profession is exempt in the hands of the Investment fund. Such income is taxable in the hands of the unit holders as if he had directly made the investment. Section 115UB(3) provides the nature of such income from Investment Fund in the hands of unit holders[3].

(2) Income under the head "Profits and gains of business or profession" is taxable in the hands of the Investment Fund. Hence, such income is exempt in the hands of the unit holders as per section 10(23FBB).

(ii) Where in any previous year, the net result of computation of total income of the investment fund [without providing for exemption under section 10(23FBA)] is a loss under any head of income and such loss cannot be or is not wholly set-off against income under any other head of income of the said previous year, then, the same has to be carried forward for set-off as per Chapter VI at the Fund level. Consequently, the loss incurred by the Investment Fund under any head of income cannot be passed on to the investors.

Accordingly, in case of Investment Fund N, the business loss of ₹ 1,50,000 has to be set-off against income from other sources of ₹ 9,00,000. The balance income of ₹ 7,50,000 is taxable in the hands of the unit holders. Loss of ₹ 4,50,000 under the head "Capital gains" cannot be set-off against income from other sources. The same has to be carried forward by Investment Fund N for set-off against income under the head "Capital gains" in the A.Y.2017-18.

(iii) Dividend distribution tax leviable under Chapter XII-D and tax on distributed income leviable under Chapter XII-E would not apply to income paid by an Investment Fund to its unit holders. Therefore, no distribution tax is payable by the Investment Funds on income distributed to its unit holders.

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[3] As per section 115UB(3), the income paid or credited by the Investment Fund shall be deemed to be of the same nature and in the same proportion in the hands of the unit holder as if it had been received by, or had accrued or arisen to, the Investment Fund.

(iv) Section 115UB(6) provides that if the income accruing or arising to, or received by, an Investment Fund, during a previous year is not paid or credited to the unit-holders, it shall be deemed to have been credited to the account of the unit-holder on the last day of the previous year in the same proportion in which such person would have been entitled to receive the income had it been paid in the previous year.

Therefore, income chargeable to tax in the hands of unit holders would not undergo a change, even if the Investment Funds do not distribute the entire income earned by them during the P.Y.2015-16 to the unit holders by 31.3.2016.

14. As per section 80AC, while computing the total income of an assessee of a previous year ***(P.Y. 2015-16, in this case)*** relevant to any assessment year ***(A.Y. 2016-17, in this case)***, any deduction is admissible, *inter alia,* under section 80-IA, such deduction shall not be allowed unless it furnishes a return of income for such assessment year on or before the due date specified in section 139(1).

Since the turnover of the partnership firm M/s.XYZ has exceeded ₹ 100 lakhs in the previous year 2015-16, it would be subject to audit under section 44AB, in which case the due date of filing its return of income for A.Y.2016-17 would be 30th September, 2016 as per section 139(1).

Computation of total income and tax liability of M/s. XYZ for A.Y.2016-17

I. Where the firm files its return of income on 30th September 2016:

Particulars	₹ in lakhs
Gross Total Income	420.00
Less: Deduction under section 80-IA	340.00
Total Income	**80.00**
Tax liability@30%	24.00
Add: Education cess@2% and secondary and higher education cess@1%	0.72
Regular income-tax payable	**24.72**
Computation of Alternate Minimum Tax payable [Section 115JC]	
Total Income	80.00
Add: Deduction under section 80-IA	340.00
Adjusted Total Income	**420.00**
Alternate Minimum Tax (AMT) @ 18.5% on ₹ 420 lakhs	**77.70**
Add: Surcharge@12% (Since adjusted total income > ₹ 1 crore)	9.32
	87.02
Add: Education cess@2% and SHEC@1%	2.61
Total tax payable (AMT)	**89.63**

Since the regular income-tax payable by the firm is less than the alternate minimum tax payable, the adjusted total income shall be deemed to be the total income of the firm for P.Y.2015-16 and it shall be liable to pay income-tax on such total income@18.5% **[Section 115JC(1)]**. Therefore, the tax payable for the A.Y.2016-17 would be ₹ 89.63 lakhs.

Tax credit for Alternate Minimum Tax [Section 115JD]	₹ in lakhs
Total tax payable for A.Y.2016-17 (Alternate Minimum Tax)	89.63
Less: Regular income-tax payable	24.72
To be carried forward for set-off against regular income-tax payable (upto a maximum of ten assessment years).	64.91

II. Where the firm files its return of income in December 2016:

Where the firm files its return in December, 2016, it would be a belated return under section 139(4). Consequently, as per section 80AC, deduction under section 80-IA would not be available. In such circumstances, the gross total income of ₹ 420 lakhs would be the total income of the firm.

Particulars	₹ in lakhs
Income-tax@30% of ₹ 420 lakhs	126.00
Add: Surcharge@12% (since total income exceeds ₹ 100 lakhs)	15.12
Income-tax (plus surcharge)	141.12
Add: Education cess@2% and SHEC@1%	4.23
Total tax liability	**145.35**

Right course of action to minimize tax liability

The right course of action to minimize tax liability would be to file the return of income under section 139(1) on or before the due date 30.9.2016 and claim deduction under section 80-IA. In such a case, the firm can claim deduction of ₹ 340 lakhs under section 80-IA. Thereafter, consequent to the clarifications obtained, if any change is required, it can file a revised return under section 139(5) within 31.3.2018 (i.e., within one year from the end of A.Y.2016-17) which would replace the original return filed under section 139(1). A return filed under section 139(1) [i.e., on or before the due date of filing return of income] can only be revised under section 139(5). A belated return filed under section 139(4) cannot be revised.

If the firm files the return of income under section 139(1) on or before 30.9.2016, its tax liability would stand reduced to ₹ 89.63 lakhs, as against ₹ 145.35 lakhs to be paid if return is furnished after due date. Further, it would also be eligible for tax credit for alternate minimum tax under section 115JD to the extent of ₹ 64.91 lakhs. Therefore, the firm is advised to file its return of income on or before 30.9.2016.

15. **Computation of total income of Mr. Vikas for A.Y.2015-16**

Particulars	₹	₹
Income from House Property [House situated in Country B]		
Gross Annual Value[4]	3,30,000	
Less: Municipal taxes paid in Country B	10,000	
Net Annual Value	3,20,000	
Less: Deduction under section 24 – 30% of NAV	96,000	
		2,24,000
Profits and Gains of Business or Profession		
Income from business carried on in India		9,20,000
Income from Other Sources		
Interest on savings bank with IDBI Bank	24,000	
Agricultural income in Country A	72,000	
Dividend received from a company in Country B	2,25,000	
Royalty income from a book of art in Country A (after deducting expenses of ₹ 70,000)	7,30,000	10,51,000
Gross Total Income		**21,95,000**
***Less:* Deduction under Chapter VIA**		
Under section 80QQB – Royalty income of a resident from a work of art[5]		3,00,000
Under section 80TTA – Interest on savings bank account, subject to a maximum of ₹10,000.		10,000
Total Income		**18,85,000**

Computation of tax liability of Mr. Vikas for A.Y.2015-16

Particulars	₹
Tax on total income [30% of ₹ 8,85,000 + ₹ 1,25,000]	3,90,500
Add: Education cess and SHEC@3%	11,715
	4,02,215
Less: Rebate under section 91 **(See Working Note below)**	1,56,057
Tax Payable	**2,46,158**
Tax payable (rounded off)	2,46,160

[4] Rental income has been taken as GAV in the absence of other information relating to fair rent, municipal value etc.

[5] It is assumed that the royalty earned outside India has been brought into India in convertible foreign exchange within a period of six months from the end of the previous year.

Calculation of Rebate under section 91:		₹
Average rate of tax in India [i.e., ₹ 4,02,215 / ₹ 18,85,000 x 100]	**21.34%**	
Average rate of tax in country A	**12%**	
Doubly taxed income pertaining to country A[6]	**₹**	
Agricultural Income	72,000	
Royalty Income [₹ 8,00,000 – ₹ 70,000 (Expenses) – ₹ 3,00,000 (deduction under section 80QQB)]	4,30,000	
	5,02,000	
Rebate under section 91 on ₹ 5,02,000 @12% [being the lower of average Indian tax rate (21.34%) and foreign tax rate (12%)]		60,240
Average rate of tax in country B	**23%**	
Doubly taxed income pertaining to country B		
Income from house property	2,24,000	
Dividend	2,25,000	
	4,49,000	
Rebate under section 91 on ₹ 4,49,000 @21.34% (being the lower of average Indian tax rate (21.34%) and foreign tax rate (23%)]		95,817
Total rebate under section 91 (Country A + Country B)		**1,56,057**

Note: Mr. Vikas shall be allowed deduction under section 91, since the following conditions are fulfilled:-

(a) He is a resident in India during the relevant previous year i.e., P.Y.2015-16.

(b) The income in question accrues or arises to him outside India in foreign countries A & B during that previous year and such income is not deemed to accrue or arise in India during the previous year.

(c) The income in question has been subjected to income-tax in the foreign countries "A" and "B" in his hands and it is presumed that he has paid tax on such income in those countries.

[6] Doubly taxed income includes only that part of income which is included in the assessees total income. The amount deducted under Chapter VIA is not doubly taxed and hence, no relief is allowable in respect of such amount – *CIT v. Dr. R.N. Jhanji (1990) 185 ITR 586 (Raj.).*

(d) There is no agreement under section 90 for the relief or avoidance of double taxation between India and Countries A and B where the income has accrued or arisen.

16. As per section 147, the Assessing Officer may assess or reassess such income **and also** any other income chargeable to tax which has escaped assessment and which comes to his notice in the course of proceedings under that section.

The issue under consideration is whether the Assessing Officer can make an assessment on the basis of an issue which came to his notice during the course of assessment, when the issues, which originally formed the basis of issue of notice under section 148, were dropped in its entirety.

There are two different views in this regard. One view is based on the Delhi High Court ruling in *Ranbaxy Laboratories Ltd. v. CIT (2011) 336 ITR 136.* Another view is based on the Punjab & Haryana High Court ruling in *CIT v. Mehak Finvest P Ltd (2014) 367 ITR 769.*

The Delhi High Court, in *Ranbaxy Laboratories Ltd. v. CIT (2011) 336 ITR 136*, observed that the words "and also" used in section 147 are of wide amplitude. The language of the section is indicative of the position that the assessment or reassessment must be of the income, in respect of which the Assessing Officer has formed a 'reason to believe' for the issue of notice under section 148 **and also** in respect of any other income which comes to his notice subsequently during the course of the proceedings as having escaped assessment. The correct interpretation, therefore, would be to regard the words **'and also'** as being "conjunctive and cumulative with" and not "in alternative to" the first part of the sentence, namely, "the Assessing Officer may assess and reassess such income".

If the income, the escapement of which was the basis of the formation of the "reason to believe", is not assessed or reassessed, it would not be open to the Assessing Officer to independently assess only that income which comes to his notice subsequently in the course of the proceedings under the section as having escaped assessment. If he intends to do so, a fresh notice under section 148 would be necessary.

Considering the rationale of the Delhi High Court ruling, the action of the Assessing Officer in passing a reassessment order under section 147 by making additions on account of disallowances under section 40A(2) in respect of other expenses, when the original "reasons to believe" ceased to exist, is not valid.

However, the Punjab & Haryana High Court, in *Mehak Finvest P Ltd.'s* case, expressed a different view on this issue, based on *Explanation 3* to section 147, which clarifies that the Assessing Officer may, for the purpose of assessment or reassessment under this section, assess or reassess the income in respect of any issue, which has escaped assessment, and such issue comes to his notice subsequently in the course of the proceedings under this section, notwithstanding that the reasons for such issue have not been included in the reasons recorded under section 148(2). The High Court noted that *Explanation 3 to section 147* nowhere postulates or contemplates that the Assessing Officer cannot make any additions on any other ground unless some addition is made on the basis of the original

ground for which reassessment proceeding was initiated. It cited the dismissal of special leave petition (SLP) against the High Court ruling in *Majinder Singh Kang's* case by the Supreme Court on 19.08.2011 as the binding precedent.

The Punjab & Haryana High Court, accordingly, held that even though no addition is made on the original grounds which formed the basis of initiation of reassessment proceedings, the Assessing Officer is empowered to make additions on another ground for which reassessment notice might not have been issued but which came to his notice subsequently during the course of proceedings for reassessment

If the rationale of the Punjab & Haryana High Court ruling is applied to the case on hand, the action of the Assessing Officer in passing a reassessment order under section 147 by making additions on account of disallowance under section 40A(2) in respect of other expenses, when the original "reasons to believe" ceased to exist, is valid.

***Note** – The question can be answered on the basis of the rationale of the Delhi High Court ruling in Ranbaxy Laboratories' case or the Punjab and Haryana High Court ruling in Mehak Finvest P Ltd.' s case.*

17. (i) **The statement is not correct.**

The Bombay High Court, in CIT v. Pruthvi Brokers & Shareholders (2012) 349 ITR 336, observed the decision of the Supreme Court, in the case of *Jute Corporation of India Ltd. v. CIT (1991) 187 ITR 688* and *National Thermal Power Corporation. Ltd v. CIT (1998) 229 ITR 383*, that an assessee is entitled to raise additional claims before the appellate authorities. The appellate authorities have jurisdiction to permit additional claims before them, however, the exercise of such jurisdiction is entirely the authorities' discretion.

The Bombay High Court held that additional grounds can be raised before the Appellate Authority even otherwise than by way of filing return of income. However, in case the claim has to be made before the Assessing Officer, the same can only be made by way of filing a revised return of income.

(ii) **The statement is not correct.**

In *CIT v. Earnest Exports Ltd. (2010) 323 ITR 577,* the Bombay High Court observed that the power under section 254(2) is limited to rectification of a mistake apparent on record and therefore, the Tribunal must restrict itself within those parameters. Section 254(2) is not a carte blanche for the Tribunal to change its own view by substituting a view which it believes should have been taken in the first instance. Section 254(2) is not a mandate to unsettle decisions taken after due reflection. The High Court, therefore, held that re-appreciation of the correctness of the earlier decision on merits is beyond the scope of the power conferred under section 254(2)

18. Under section 263(1), if the Principal Commissioner or Commissioner considers that any order passed by the Assessing Officer **is erroneous in so far as it is prejudicial to the**

interests of the Revenue, he may, after giving the assessee an opportunity of being heard and after making an enquiry, pass an order enhancing or modifying the assessment made by the Assessing Officer or cancelling the assessment and directing fresh assessment.

Explanation 2 has been inserted by the Finance Act, 2015 with effect from 1st June, 2015 to provide that an order passed by the Assessing Officer shall be deemed to be erroneous in so far as it is prejudicial to the interests of the Revenue, if, in the opinion of the Principal Commissioner or Commissioner,—

(1) the order is passed without making inquiries or verification which should have been made;

(2) the order is passed allowing any relief without inquiring into the claim;

(3) the order has not been made in accordance with any order, direction or instruction issued by the CBDT under section 119;

(4) the order has not been passed in accordance with any decision which is prejudicial to the assessee, rendered by the jurisdictional High Court or Supreme Court in the case of the assessee or any other person.

19. The issue under consideration in this case is whether making an incorrect claim in the return of income would tantamount to concealment of particulars or furnishing of inaccurate particulars for attracting the penal provisions under section 271(1)(c) when no information given in the return of income is found to be incorrect.

This issue came up before the Supreme Court in *CIT v. Reliance Petro Products Pvt. Ltd. (2010) 322 ITR 158*. The Supreme Court observed that in order to attract the penal provisions of section 271(1)(c), there has to be concealment of the particulars of income or furnishing inaccurate particulars of income. Where no information given in the return is found to be incorrect or inaccurate, the assessee cannot be held guilty of furnishing inaccurate particulars. Making an incorrect claim (i.e. a claim which has been disallowed) would not, by itself, tantamount to furnishing inaccurate particulars.

The Apex Court held that where there is no finding that any details supplied by the assessee in its return are incorrect or erroneous or false, there is no question of imposing penalty under section 271(1)(c). A mere making of a claim, which is not sustainable in law, by itself, will not amount to furnishing inaccurate particulars regarding the income of the assessee.

Applying the rationale of the above Supreme Court ruling to the case on hand, penalty under section 271(1)(c) cannot be imposed on PQR Ltd. merely for making an incorrect claim which is not sustainable in law, since the company had furnished all the details in the return of income correctly and no information given by the company was found to be incorrect or erroneous or false.

The contention of PQR Ltd. is, therefore, correct.

20. **(i) The statement is not correct.**

Section 194A(3)(v) has been amended by the Finance Act, 2015 to specifically provide that with effect from 1st June, 2015, the exemption available thereunder from deduction of tax at source from payment of interest to members by a co-operative society shall not apply to the payment of interest by the co-operative banks to its members.

However, the exemption available under section 194A(3)(viia)(a) to primary agricultural credit society or a primary credit society or a co-operative land mortgage bank or a co-operative land development bank from deduction of tax in respect of interest credited or paid on deposits shall continue to apply. Therefore, these co-operative credit societies/banks would not be required to deduct tax on interest credited or paid to depositors consequent to amendment of section 194A(3)(v).

Further, the exemption under section 194A(3)(v) from deduction of tax from interest paid by a co-operative society to another co-operative society shall continue to apply to co-operative banks and, therefore, a co-operative bank shall not be required to deduct tax from the payment of interest on time deposit to a depositor, being a co-operative society.

(ii) The statement is not correct.

Prior to amendment by the Finance Act, 2015, the definition of "time deposits" under section 194A excluded "recurring deposit" from its scope. Therefore, payment of interest on recurring deposits by banking company or co-operative bank was not subject to TDS under section 194A.

Since recurring deposit is also made for a fixed tenure and is, therefore, similar to time deposit, the definition of 'time deposits' in section 194A has been amended by the Finance Act, 2015 with effect from 1st June, 2015 to include "recurring deposits" within its scope for the purposes of deduction of tax under section 194A. Therefore, interest on recurring deposits would now be subject to tax deduction under section 194A. It may be noted that the existing threshold limit of ₹ 10,000 for non-deduction of tax shall also be applicable in case of interest payment on recurring deposits.

Applicability of Finance Act, Assessment Year etc. for May, 2016 – Final Examination

Paper 7 : Direct Tax Laws & Paper 8 : Indirect Tax Laws

Applicability of Finance Act, Assessment Year etc. for May, 2016 Examination

The provisions of direct tax laws (income-tax) and indirect tax laws, as amended by the Finance Act, 2015, including notifications and circulars issued up to 31st October, 2015, are applicable for May, 2016 examination. The relevant assessment year for Paper 7: Direct Tax Laws is A.Y.2016-17.

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ANNEXURE

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Part I: Statutory Update – Direct Tax Laws

Significant Notifications and Circulars issued between 1.5.2015 and 31.10.2015

I. NOTIFICATIONS

1. Nature of Business Relationship, for the purpose of clause (b)(viii) of *Explanation* below section 288(2), prescribed [Notification No. 50/2015, dated 24.6.2015]

Explanation below section 288(2) defines an "accountant" to mean a "Chartered Accountant" as defined in section 2(1)(b) of the Chartered Accountants Act, 1949, holding a valid certificate of practice under section 6(1) of the said Act, but does not include [except for appearing as an authorized representative under section 288(1)] in case of a non-corporate assessee, *inter alia* a person who, whether directly or indirectly, has **business relationship with the assessee** of such nature as may be prescribed.

Consequently, the CBDT has, in exercise of the powers conferred by section 295 read with sub-clause (b) (*viii*) of *Explanation* below section 288(2), inserted Rule 51A prescribing the nature of business relationship. Accordingly, the term "business relationship" shall be construed as any transaction **entered into for a commercial purpose, other than**,—

(i) commercial transactions which are **in the nature of professional services** permitted to be rendered by an auditor or audit firm under the Act and the Chartered Accountants Act, 1949 and the rules or the regulations made under those Acts;

(ii) commercial transactions which are **in the ordinary course of business of the entity at arm's length price** - like sale of products or services to the auditor, as customer, in the ordinary course of business, by entities engaged in the business of telecommunications, airlines, hospitals, hotels and such other similar businesses."[1]

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[1] Section 141(3) of the Companies Act, 2013 contains a similar disqualification in case of a company; for which purpose "business relationship" has been defined in the like manner in Rule 10(4) of the Companies (Audit & Auditors) Rules, 2014. It may be noted that in case of a company, a person who is not eligible for appointment as an auditor of the said company in accordance with section 141(3) of the Companies Act, 2013 is not included in the definition of "accountant" [except for appearing as an authorised representative under section 288(1)]

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2. **No tax to be deducted in respect of the income specified under section 10(23FBA) received by an Investment Fund [Notification No. 51/2015, dated 24.6.2015]**

Section 197A(1F) provides that no deduction of tax shall be made from such specified payment to such institution, association or body or class of institutions, associations or bodies as may be notified by the Central Government.

Accordingly, the Central Government has, vide this notification, notified that no tax has to be deducted in respect of **payments of the nature specified in section 10(*23FBA*)** [i.e., any income other than the income chargeable under the head "Profits and gains of business or profession"] **received by any investment fund.**[2]

3. **Notification of Cost Inflation Index for Financial Year 2015-16 [Notification No. 60/2015, dated 24.7.2015]**

Clause (v) of Explanation to section 48 defines "Cost Inflation Index", in relation to a previous year, to mean such Index as the Central Government may, by notification in the Official Gazette, specify in this behalf, having regard to 75% of average rise in the Consumer Price Index (Urban) for the immediately preceding previous year to such previous year.

Accordingly, the Central Government has, in exercise of the powers conferred by clause (v) of Explanation to section 48, specified the Cost Inflation Index for the **financial year 2015-16 as 1081**.

S. No.	Financial Year	Cost Inflation Index	S. No.	Financial Year	Cost Inflation Index
1.	1981-82	100	19.	1999-2000	389
2.	1982-83	109	20.	2000-01	406
3.	1983-84	116	21.	2001-02	426
4.	1984-85	125	22.	2002-03	447
5.	1985-86	133	23.	2003-04	463
6.	1986-87	140	24.	2004-05	480
7.	1987-88	150	25.	2005-06	497
8.	1988-89	161	26.	2006-07	519
9.	1989-90	172	27.	2007-08	551

[2] "Investment Fund" means any fund established or incorporated in India in the form of a trust or a company or a LLP or a body corporate which has been granted a certificate of registration as a Category I or a Category II Alternative Investment Fund and is regulated under the SEBI (AIF) Regulations, 2012, made under the SEBI Act, 1992.

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10.	1990-91	182	28.	2008-09	582
11.	1991-92	199	29.	2009-10	632
12.	1992-93	223	30.	2010-11	711
13.	1993-94	244	31.	2011-12	785
14.	1994-95	259	32.	2012-13	852
15.	1995-96	281	33.	2013-14	939
16.	1996-97	305	34.	2014-15	1024
17.	1997-98	331	**35.**	**2015-16**	**1081**
18.	1998-99	351			

4. **Basis for determining the period of stay in India for an Indian citizen, being a member of the crew of a foreign bound ship leaving India [Notification No. 70/2015, dated 17.8.2015]**

Section 6(1) of the Income-tax Act, 1961 provides that an individual is said to be resident in India in any previous year, if he—

(a) is in India in that year for a period or periods amounting in all to 182 days or more; or

(b) having within the four years preceding that year been in India for a period or periods amounting in all to 365 days or more, is in India for a period or periods amounting in all to 60 days or more in that year.

However, where an Indian citizen leaves India as a member of crew of an Indian ship or for the purpose of employment outside India, he will be resident only if he stayed in India for 182 days during the previous year.

Thus, under section 6(1), the conditions to be satisfied by an individual to be a resident in India are provided. The residential status is determined on the basis of the **number of days of his stay in India** during a previous year.

However, in case of **foreign bound ships** where the destination of the **voyage is outside India**, there is **uncertainty** regarding the manner and the basis of **determining the period of stay in India for an Indian citizen, being a crew member**.

To remove this uncertainty, ***Explanation 2*** **has been inserted to section 6(1)** to provide that in the case of an individual, being a citizen of India and a member of the crew of a foreign bound ship leaving India, the **period or periods of stay in India** shall, in respect of such voyage, be determined in the **prescribed manner** and subject to the prescribed conditions.

Accordingly, the CBDT has, in exercise of the powers conferred by *Explanation 2* to section 6(1) read with section 295, vide this notification, with retrospective effect

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from 1st April, 2015, inserted Rule 126 in the Income-tax Rules, 1962 to compute the period of stay in such cases.

According to Rule 126, in case of an individual, being a citizen of India and a member of the crew of a ship, the **period or periods of stay in India** shall, in respect of an eligible voyage, **not include** the period **commencing from the date** entered into the Continuous Discharge Certificate in respect of **joining the ship** by the said individual for the eligible voyage and **ending on the date** entered into the Continuous Discharge Certificate in respect of **signing off by that individual from the ship** in respect of such voyage.

The Explanation to this Rule defines the meaning of the following terms:

Terms	Meaning
Continuous Discharge Certificate	This term has the meaning assigned to it in the Merchant Shipping (Continuous Discharge Certificate-cum-Seafarer's Identity Document) Rules, 2001 made under the Merchant Shipping Act, 1958.
Eligible voyage	A voyage undertaken by a ship engaged in the carriage of passengers or freight in international traffic where- (i) for the voyage having originated from any port in India, has as its destination any port outside India; and (ii) for the voyage having originated from any port outside India, has as its destination any port in India.

5. **Certain districts of Bihar notified as backward areas under the first proviso to section 32(1)(iia) and section 32AD(1) [Notification No. 71/2015, dated 17.8.2015]**

In order to encourage the setting up of industrial undertakings in the backward areas of the States of Andhra Pradesh, Bihar, Telangana and West Bengal, section 32AD(1) provides for a deduction of an amount equal to 15% of the actual cost of new plant and machinery acquired and installed in the assessment year relevant to the previous year in which such plant and machinery is installed, if the following conditions are satisfied by the assessee–

(a) the assessee sets up an undertaking or enterprise for manufacture or production of any article or thing on or after 1st April, 2015 in any backward area notified by the Central Government in the State of Andhra Pradesh or Bihar or Telangana or West Bengal; and

(b) the assessee acquires and installs new plant and machinery for the purposes

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of the said undertaking or enterprise during the period between 1st April, 2015 and 31st March, 2020 in the said backward areas.

Further, in order to encourage acquisition and installation of plant and machinery for setting up of manufacturing units in the notified backward areas of the States of Andhra Pradesh, Bihar, Telangana and West Bengal, first proviso has been inserted to section 32(1)(iia) to allow higher additional depreciation at the rate of 35% (instead of 20%) in respect of the actual cost of new machinery or plant (other than a ship and aircraft) acquired and installed during the period between 1st April, 2015 and 31st March, 2020 by a manufacturing undertaking or enterprise which is set up in the notified backward areas of these specified States on or after 1st April, 2015.

Accordingly, the Central Government has, vide this notification, notified the following **21 districts of the State of Bihar** as backward areas under the first proviso to section 32(1)(iia) and section 32AD(1): -

S. No.	District	S. No.	District
1.	Patna	12.	Samastipur
2.	Nalanda	13.	Darbhanga
3.	Bhojpur	14.	Madhubani
4.	Rohtas	15.	Purnea
5.	Kaimur	16.	Katihar
6.	Gaya	17.	Araria
7.	Jehanabad	18.	Jamui
8.	Aurangabad	19.	Lakhisarai
9.	Nawada	20.	Supaul
10.	Vaishali	21.	Muzaffarpur
11.	Sheohar		

6. News agency notified for the purpose of section 10(22B) [Notification No. 72/2015, dated 24.8.2015]

Section 10(22B) provides that any income of a news agency set up in India solely for collection and distribution of news as the Central Government may notify shall be exempt, subject to the condition that such news agency applies its income or accumulates it for application solely for collection and distribution of news and does not distribute its income in any manner to its members.

Accordingly, the Central Government has, through this notification, specified the **Press Trust of India Limited, New Delhi** as a news agency set up in India solely for collection and distribution of news, for the purpose of section 10(22B) for three

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assessment years 2016-17 to 2018-19. The income of such news agency will not be included in computing the total income of a previous year of such agency for these three years, provided it applies its income or accumulates it for application solely for collection and distribution of news and does not distribute its income in any manner to its members.

7. **Exemption in respect of transport allowance under Rule 2BB extended to deaf and dumb employees [Notification No. 75/2015, dated 23.09.2015]**

   The CBDT has, in exercise of the powers conferred by section 295 read with section 10(14), amended Rule 2BB, which *inter alia* provides the limit of exemption of up to ₹ 1,600 p.m., in respect of transport allowance granted to an employee and up to ₹ 3,200 p.m., for an employee who is blind or orthopedically handicapped, with disability of lower extremities, to meet his expenditure for the purpose of commuting between the place of his residence and the place of his duty.

   Consequent to the amendment made vide this notification, the exemption up to ₹ 3,200 p.m. in respect of transport allowance can be claimed by a blind ***or deaf and dumb*** or orthopedically handicapped employee with disability of lower extremities to meet his expenditure for the purpose of commuting between the place of his residence and the place of his duty.

8. **Simplification of format and procedure for self-declaration in Form No.15G & 15H [Notification No. 76/2015, dated 29.09.2015]**

   Tax payers seeking non-deduction of tax from certain incomes are required to file a self-declaration in Form No. 15G or Form No.15H as per section 197A. In order to reduce the cost of compliance and ease the compliance burden for both the tax payer and the tax deductor, the CBDT has simplified the format and procedure for self-declaration of Form No.15G or 15H. The procedure for submission of the Forms by the deductor has also been simplified.

   Under the simplified procedure contained in new Rule 29C, a payee can submit the self-declaration either in paper form or electronically. The deductor will not deduct tax and will allot a Unique Identification Number (UIN) to all self-declarations in accordance with the procedure as specified by the Principal Director General of Income-tax (Systems) under sub-rule (7) of new Rule 29C. The particulars of self-declarations will have to be furnished by the deductor along with UIN in the quarterly TDS statements. The requirement of submitting physical copy of Form 15G and 15H by the deductor to the income-tax authorities has been dispensed with. The deductor will, however be required to retain Form No.15G and 15H for seven years. The revised procedure shall be effective from 1st October, 2015.

9. **Transfer Pricing Rules amended to incorporate "range concept" and "use of multi-year data" [Notification No. 83/2015, dated 19.10.2015]**

   Section 92C(2) provides that the arm's length price (ALP) in relation to an

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international transaction or specified domestic transaction has to be determined by applying the most appropriate method.

As per the first proviso to section 92C(2), where more than one price is determined by applying the most appropriate method, the ALP shall be taken to be the arithmetical mean of such prices.

However, if the variation between the ALP so determined and the price at which the international transaction or specified domestic transaction has actually been undertaken does not exceed such percentage, not exceeding 3%, as may be notified by the Central Government, the price at which the transaction has actually been undertaken would be deemed to be the ALP.

In the year 2014, the Finance Minister, in his budget speech, had proposed to introduce the "range concept" for determination of ALP, for aligning Transfer Pricing Regulations in India with the best practices.

Accordingly, a third proviso was inserted in section 92C(2) to provide that in case of an international transaction or specified domestic transaction undertaken on or after 1.4.2014, where more than one price is determined by the most appropriate method, the ALP shall be computed in the prescribed manner (based on "range concept" to be specified by way of Rules) and the computation methodology given in the first and second proviso, based on arithmetic mean, shall be ignored.

The CBDT has, in exercise of the powers conferred by section 92C read with section 295 prescribed the manner of computation of arm's length price applicable for international transactions and specified domestic transactions undertaken on or after 1.4.2014.

Incorporation of "Range Concept" in Transfer Pricing Rules

In case of an international transaction or specified domestic transaction undertaken on or after 1.4.2014, where more than one price is determined by the most appropriate method, the arm's length price shall be computed in the prescribed manner specified in Rule 10CA.

Rule 10CA(1) provides that where in respect of an international transaction or a specified domestic transaction, the application of the most appropriate method referred to in section 92C(1) **results in determination of more than one price**, then, the arm's length price in respect of such international transaction or specified domestic transaction has to be computed on the basis of the **dataset constructed by placing such prices in an ascending order** as provided in Rule 10CA(2).

However, where the most appropriate method is the resale price method or cost plus method or transactional net margin method and the comparable uncontrolled transaction has been identified on the basis of data relating to the current year and the enterprise undertaking the said uncontrolled transaction, [not being the enterprise undertaking the international transaction or the specified domestic

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transaction referred to in sub-rule (1)], has in either or both of the two financial years immediately preceding the current year undertaken the same or similar comparable uncontrolled transaction then,-

(i) the most appropriate method used to determine the price of the comparable uncontrolled transaction undertaken in the current year shall be applied in similar manner to the comparable uncontrolled transaction or transactions undertaken in the aforesaid period and the price in respect of such uncontrolled transactions shall be determined; and

(ii) the weighted average of the prices, computed in accordance with the manner provided in sub-rule (3), of the comparable uncontrolled transactions undertaken in the current year and in the aforesaid period preceding it shall be included in the dataset instead of the price referred to in sub-rule (1).

Further, where the most appropriate method is the resale price method or cost plus method or transactional net margin method where the comparable uncontrolled transaction has been identified on the basis of the data relating to the financial year immediately preceding the current year and the enterprise undertaking the said uncontrolled transaction, [not being the enterprise undertaking the international transaction or the specified domestic transaction referred to in sub-rule (1)], has in the financial year immediately preceding the said financial year undertaken the same or similar comparable uncontrolled transaction then, -

(i) the price in respect of such uncontrolled transaction shall be determined by applying the most appropriate method in a similar manner as it was applied to determine the price of the comparable uncontrolled transaction undertaken in the financial year immediately preceding the current year; and

(ii) the weighted average of the prices, computed in accordance with the manner provided in sub-rule (3), of the comparable uncontrolled transactions undertaken in the aforesaid period of two years shall be included in the dataset instead of the price referred to in sub-rule (1).

Also, in such cases, where the use of data relating to the current year for determination of ALP subsequently at the time of assessment establishes that,-

(i) the enterprise has not undertaken same or similar uncontrolled transaction during the current year; or

(ii) the uncontrolled transaction undertaken by an enterprise in the current year is not a comparable uncontrolled transaction,

then, irrespective of the fact that such an enterprise had undertaken comparable uncontrolled transaction in the financial year immediately preceding the current year or the financial year immediately preceding such financial year, the price of comparable uncontrolled transaction or the weighted average of the prices of the uncontrolled transactions, as the case may be, undertaken by such enterprise shall

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not be included in the dataset.

Rule 10CA(3) provides that where an enterprise has undertaken comparable uncontrolled transactions in more than one financial year, then for the purposes of sub-rule (2) the weighted average of the prices of such transactions shall be computed in the following manner, namely:-

	Method used to determine the prices	**Manner of computation of weighted average of the prices**
(i)	The resale price method	By assigning weights to the quantum of sales which has been considered for arriving at the respective prices
(ii)	The cost plus method	By assigning weights to the quantum of costs which has been considered for arriving at the respective prices
(iii)	The transactional net margin method	By assigning weights to the quantum of costs incurred or sales effected or assets employed or to be employed, or as the case may be, any other base which has been considered for arriving at the respective prices.

Rule 10CA(4) provides that where the most appropriate method applied is –

(i) a method other than the profit split method or a method prescribed by the CBDT under section 92C(1)(f); and

(ii) the dataset constructed in accordance with sub-rule (2) consists of six or more entries,

an arm's length range beginning from the thirty-fifth percentile of the dataset and ending on the sixty-fifth percentile of the dataset shall be constructed.

If the price at which the international transaction or the specified domestic transaction has actually been undertaken is within the said range, then, the price at which such international transaction or the specified domestic transaction has actually been undertaken shall be deemed to be the arm's length price [Rule 10CA(5)].

If the price at which the international transaction or the specified domestic transaction has actually been undertaken is outside the said arm's length range, the arm's length price shall be taken to be the median of the dataset [Rule 10CA(6)].

In a case where the provisions of Rule 10CA(4) are not applicable, the arm's length price shall be the arithmetical mean of all the values included in the dataset. However, if the variation between the arm's length price so determined and price at which the international transaction or specified domestic transaction has actually

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been undertaken does not exceed such percentage not exceeding three percent. of the latter, as may be notified[3] by the Central Government in the Official Gazette in this behalf, the price at which the international transaction or specified domestic transaction has actually been undertaken shall be deemed to be the arm's length price [Rule 10CA(7)].

Meaning of certain terms [Rule 10CA(8)]

	Term	Meaning
(a)	the thirty-fifth percentile of a dataset (having values arranged in an ascending order)	The lowest value in the dataset such that at least 35% of the values included in the dataset are equal to or less than such value. However, if the number of values that are equal to or less than the aforesaid value is a whole number, then the thirty-fifth percentile shall be the arithmetic mean of such value and the value immediately succeeding it in the dataset.
(b)	the sixth-fifth percentile of a dataset (having values arranged in an ascending order)	The lowest value in the dataset such that at least 65% of the values included in the dataset are equal to or less than such value. However, if the number of values that are equal to or less than the aforesaid value is a whole number, then, the sixty-fifth percentile shall be the arithmetic mean of such value and the value immediately succeeding it in the dataset.
(c)	the median of the dataset (having values arranged in an ascending order)	The lowest value in the dataset such that at least 50% of the values included in the dataset are equal to or less than such value. However, if the number of values that are equal to or less than the aforesaid value

[3] 1% in respect of wholesale trading and 3% in respect of all other cases (for A.Y.2015-16) [Notification No.86/2015 dated 29.10.2015]. Wholesale trading, for this purpose, means an international transaction or specified domestic transaction of trading in goods, which fulfils the following conditions, namely:-

(i) **purchase cost** of finished goods is **80% or more of the total cost** pertaining to such trading activities; and

(ii) **average monthly closing** inventory of such goods is **10% or less of sales** pertaining to such trading activities.

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		is a whole number, then, the median shall be the arithmetic mean of such value and the value immediately succeeding it in the dataset.

Use of multiple year data:

Sub-rule (5) has been inserted in Rule 10B to provide that in case the most appropriate method for determination of ALP of a transaction entered into on or after 1.4.2014 is the resale price method or cost plus method or the transactional net margin method, then, the data to be used for analyzing the comparability of an uncontrolled transaction with an international transaction shall be –

(a) the data relating to the current year; or

(b) the data relating to the financial year immediately preceding the current year, if the data relating to the current year is not available at the time of furnishing the return of income by the assessee, for the assessment year relevant to the current year.

However, where the data relating to the current year is subsequently available at the time of determination of arm's length price of an international transaction or a specified domestic transaction during the course of any assessment proceeding for the assessment year relevant to the current year, then, such data shall be used for such determination irrespective of the fact that the data was not available at the time of furnishing the return of income of the relevant assessment year.

II. CIRCULARS

1. Tax not to be deducted from payments made to Corporations whose income is exempt under section 10(26BBB) [Circular No. 7/2015, dated 23-04-2015]

The CBDT had earlier issued Circular No. 4/2002 dated 16.07.2002 which laid down that there would be no requirement for tax deduction at source from payments made to such entities, whose income is unconditionally exempt under section 10 and who are statutorily not required to file return of income as per the section 139.

Section 10(26BBB), inserted by the Finance Act, 2003 w.e.f. 01.04.2004, exempts any income of a corporation established by a Central, State or Provincial Act for the welfare and economic up liftment of ex-service-men being the citizen of India. The corporations covered under section 10(26BBB) are also statutorily not required to file return of income as per the section 139.

Now, the CBDT has, vide this circular, clarified that since corporations covered under section 10(26BBB) satisfy the two conditions of Circular No. 4/2002 i.e., unconditional exemption of income under section 10 and no statutory liability to file return of income under section 139, they would also be entitled for the benefit of the said circular.

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Hence, there would be no requirement for tax deduction at source from the payments made to such corporations since their income is anyway exempt under section 10.

2. **Clarifications on Rollback Provisions of Advance Pricing Agreement Scheme [Circular No. 10/2015, dated 10-06-2015]**

An Advance Pricing Agreement (APA) is an agreement between a taxpayer and a taxing authority on an appropriate transfer pricing methodology for a set of transactions over a fixed period of time in future. They offer better assurance on transfer pricing methods and provide certainty and unanimity of approach.

Keeping in mind the benefits offered by the APAs, sections 92CC and section 92CD were introduced in the transfer pricing regime by the Finance Act, 2012 to provide a framework for formulation of APAs between the tax payer and the income-tax authorities.

Subsequently, the Advance Pricing Agreement Scheme was notified vide Notification No. 36/2012, dated 30/8/2012, thereby inserting Rules 10F to 10T and Rule 44GA in the Income-tax Rules, 1962.

In order to reduce current pending as well as future litigation in respect of the transfer pricing matters, the Finance (No. 2) Act, 2014 has inserted sub-section (9A) in section 92CC to provide for a roll back mechanism in the APA scheme.

Accordingly, the APA may, subject to such prescribed conditions, procedure and manner, provide for determining the ALP or for specifying the manner in which ALP is to be determined in relation to an international transaction entered into by a person during any period not exceeding four previous years preceding the first of the previous years for which the APA applies in respect of the international transaction to be undertaken.

The CBDT has, vide Notification No.23/2015 dated 14.3.2015, in exercise of the powers conferred by section 92CC(9) and 92CC(9A) read with section 295, prescribed the conditions, procedure and manner for determining the arm's length price or for specifying the manner in which arm's length price is to be determined in relation to an international transaction in which the roll back provisions have to be given effect to[4].

Subsequent to this notification of the rules, the CBDT has issued Circular No.10/2015 dated 10.6.2015 adopting a Question and Answer format to clarify certain issues arising out of the said Rules. The questions raised and answers to

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[4] Refer pages 16.34-16.38 of November 2015 Edition of the Study Material of Final Paper 7 : Direct Tax Laws or pages 136-140 of Supplementary Study Paper – 2015 of Final Course for Notification No.23/2015 dated 14.3.2015.

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such questions as per the said Circular are given hereunder:

Question 1

Under rule 10MA(2)(ii) there is a condition that the return of income for the relevant roll back year has been or is furnished by the applicant before the due date specified in Explanation 2 to section 139(1). It is not clear as to whether applicants who have filed returns under section 139(4) or 139(5) of the Act would be eligible for roll back.

Answer

The return of income under section 139(5) can be filed only when a return under section 139(1) has already been filed. Therefore, the return of income filed under section 139(5) of the Act, replaces the original return of income filed under section 139(1). Hence, if there is a return which is filed under section 139(5) to revise the original return filed before the due date specified in Explanation 2 to sub-section (1) of section 139, the applicant would be entitled for rollback on this revised return of income.

However, rollback provisions will not be available in case of a return of income filed under section 139(4) because it is a return which is not filed before the due date.

Question 2

Rule 10MA(2)(i) mandates that the rollback provision shall apply in respect of an international transaction that is same as the international transaction to which the agreement (other than the rollback provision) applies. It is not clear what is the meaning of the word "same". Further, it is not clear whether this restriction also applies to the Functions, Assets, Risks (FAR) analysis.

Answer

The international transaction for which a rollback provision is to be allowed should be the same as the one proposed to be undertaken in the future years and in respect of which the agreement has been reached. There cannot be a situation where rollback is finalised for a transaction which is not covered in the agreement for future years. The term same international transaction implies that the transaction in the rollback year has to be of same nature and undertaken with the same associated enterprise(s), as proposed to be undertaken in the future years and in respect of which agreement has been reached. In the context of FAR analysis, the restriction would operate to ensure that rollback provisions would apply only if the FAR analysis of the rollback year does not differ materially from the FAR validated for the purpose of reaching an agreement in respect of international transactions to be undertaken in the future years for which the agreement applies.

The word "materially" is generally being defined in the Advance Pricing Agreements being entered into by CBDT. According to this definition, the word "materially" will

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be interpreted consistently with its ordinary definition and in a manner that a material change of facts and circumstances would be understood as a change which could reasonably have resulted in an agreement with significantly different terms and conditions.

Question 3

Rule 10MA(2)(iv) requires that the application for rollback provision, in respect of an international transaction, has to be made by the applicant for all the rollback years in which the said international transaction has been undertaken by the applicant. Clarification is required as to whether rollback has to be requested for all four years or applicant can choose the years out of the block of four years.

Answer

The applicant does not have the option to choose the years for which it wants to apply for rollback. The applicant has to either apply for all the four years or not apply at all. However, if the covered international transaction(s) did not exist in a rollback year or there is some disqualification in a rollback year, then the applicant can apply for rollback for less than four years. Accordingly, if the covered international transaction(s) were not in existence during any of the rollback years, the applicant can apply for rollback for the remaining years. Similarly, if in any of the rollback years for the covered international transaction(s), the applicant fails the test of the rollback conditions contained in various provisions, then it would be denied the benefit of rollback for that rollback year. However, for other rollback years, it can still apply for rollback.

Question 4

Rule 10MA(3) states that the rollback provision shall not be provided in respect of an international transaction for a rollback year if the determination of arm's length price of the said international transaction for the said year has been the subject matter of an appeal before the Appellate Tribunal and the Appellate Tribunal has passed an order disposing of such appeal at any time before signing of the agreement. Further, Rule 10 RA(4) provides that if any appeal filed by the applicant is pending before the Commissioner (Appeals), Appellate Tribunal or the High Court for a rollback year, on the issue which is subject matter of the rollback provision for that year, the said appeal to the extent of the subject covered under the agreement shall be withdrawn by the applicant.

There is a need to clarify the phrase "Tribunal has passed an order disposing of such appeal" and on the mismatch, if any, between Rule 10MA(3) and Rule 10RA(4).

Answer

The reason for not allowing rollback for the international transaction for which Appellate Tribunal has passed an order disposing of an appeal is that the ITAT is

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the final fact finding authority and hence, on factual issues, the matter has already reached finality in that year. However, if the ITAT has not decided the matter and has only set aside the order for fresh consideration of the matter by the lower authorities with full discretion at their disposal, the matter shall not be treated as one having reached finality and hence, benefit of rollback can still be given.

There is no mismatch between Rule 10MA(3) and Rule 10RA(4).

Question 5

Rule 10MA(3)(ii) provides that rollback provision shall not be provided in respect of an international transaction for a rollback year if the application of rollback provision has the effect of reducing the total income or increasing the loss, as the case may be, of the applicant as declared in the return of income of the said year. It may be clarified whether the rollback provisions in such situations can be applied in a manner so as to ensure that the returned income or loss is accepted as the final income or loss after applying the rollback provisions.

Answer

It is clarified that in case the terms of rollback provisions contain specific agreement between the Board and the applicant that the agreed determination of ALP or the agreed manner of determination of ALP is subject to the condition that the ALP would get modified to the extent that it does not result in reducing the total income or increasing the total loss, as the case may be, of the applicant as declared in the return of income of the said year, the rollback provisions could be applied. For example, if the declared income is Rs. 100, the income as adjusted by the TPO is Rs. 120, and the application of the rollback provisions results in reducing the income to Rs. 90, then the rollback for that year would be determined in a manner that the declared income Rs. 100 would be treated as the final income for that year.

Question 6

Rule 10RA(7) states that in case effect cannot be given to the rollback provision of an agreement in accordance with this rule, for any rollback year to which it applies, on account of failure on the part of applicant, the agreement shall be cancelled. It is to be clarified as to whether the entire agreement is to be cancelled or only that year for which roll back fails.

Answer

The procedure for giving effect to a rollback provision is laid down in Rule 10RA. Sub-rules (2), (3), (4) and (6) of the Rule specify the actions to be taken by the applicant in order that effect may be given to the rollback provision. If the applicant does not carry out such actions for any of the rollback years, the entire agreement shall be cancelled.

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This is because the rollback provision has been introduced for the benefit of the applicant and is applicable at its option. Accordingly, if the rollback provision cannot be given effect to for any of the rollback years on account of the applicant not taking the actions specified in sub-rules (2), (3), (4) or (6), the entire agreement gets vitiated and will have to be cancelled.

Question 7

If there is a Mutual Agreement Procedure (MAP) application already pending for a rollback year, what would be the stand of the APA authorities? Further, what would be the view of the APA Authorities, if MAP has already been concluded for a rollback year?

Answer

If MAP has been already concluded for any of the international transactions in any of the rollback year under APA, rollback provisions would not be allowed for those international transactions for that year but could be allowed for other years or for other international transactions for that year, subject to fulfilment of specified conditions in Rules 10MA and 10RA. However, if MAP request is pending for any of the rollback year under APA, upon the option exercised by the applicant, either MAP or application for roll back shall be proceeded with for such year.

Question 8

Rule 10MA(1) provides that the agreement may provide for determining ALP or manner of determination of ALP. However, Rule 10MA(4) only specifies that the manner of determination of ALP should be the same as in the APA term. Does that mean the ALP could be different?

Answer

Yes, the ALP could be different for different years. However, the manner of determination of ALP (including choice of Method, comparability analysis and Tested Party) would be same.

Question 9

Will there be compliance audit for roll back? Would critical assumptions have to be validated during compliance audit?

Answer

Since rollback provisions are for past years, ALP for the rollback years would be agreed after full examination of all the facts, including validation of critical assumptions. Hence, compliance audit for the rollback years would primarily be to check if the agreed price or methodology has been applied in the modified return.

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Question 10

Whether applicant has an option to withdraw its rollback application? Can the applicant accept the rollback results without accepting the APA for the future years?

Answer

The applicant has an option to withdraw its roll back application even while maintaining the APA application for the future years. However, it is not possible to accept the rollback results without accepting the APA for the future years. It may also be noted that the fee specified in Rule 10MA(5) shall not be refunded even where a rollback application is withdrawn.

Question 11

For already concluded APAs, will new APAs be signed for rollback or earlier APAs could be revised?

Answer

The second proviso to Rule 10MA(5) provides for revision of APAs already concluded to include rollback provisions.

Question 12

For already concluded APAs, where the modified return has already been filed for the first year of the APA term, how will the time-limit for filing modified return for rollback years be determined?

Answer

The time to file modified return for rollback years will start from the date of signing the revised APA incorporating the rollback provisions.

Question 13

In case of merger of companies, where one or more of those companies are APA applicants, how would the rollback provisions be allowed and to which company or companies would it be allowed?

Answer

The agreement is between the Board and a person. The principle to be followed in case of merger is that the person (company) who makes the APA application would only be entitled to enter into the agreement and be entitled for the rollback provisions in respect of international transactions undertaken by it in rollback years. Other persons (companies) who have merged with this person (company) would not be eligible for the rollback provisions.

To illustrate, if A, B and C merge to form C and C is the APA applicant, then the agreement can only be entered into with C and only C would be eligible for the rollback provisions. A and B would not be eligible for the rollback provisions. To

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illustrate further, if A and B merge to form a new company C and C is the APA applicant, then nobody would be eligible for rollback provisions.

Question 14

In case of a demerger of an APA applicant or signatory into two or more companies (persons), who would be eligible for the rollback provisions?

Answer

The same principle as mentioned in the previous answer, i.e., the person (company) who makes an APA application or enters into an APA would only be entitled for the rollback provisions, would continue to apply. To illustrate, if A has applied for or entered into an APA and, subsequently, demerges into A and B, then only A will be eligible for rollback for international transactions covered under the APA. As B was not in existence in rollback years, availing or grant of rollback to B does not arise.

3. Deduction in respect of cost of production allowable under section 37 in the case of Abandoned Feature Films [Circular No. 16, dated 6.10.2015]

The deduction in respect of the cost of production of a feature film certified for release by the Board of Film Censors in a previous year is provided in Rule 9A.

In the case of abandoned films, however, since certificate of Board of Film Censors is not received, in some cases no deduction was allowed by applying Rule 9A of the Rules or by treating the expenditure as capital expenditure.

The CBDT has examined the matter in light of judicial decisions on this subject. The order of the Hon'ble Bombay High Court dated 28.1.2015 in ITA 310 of 2013 in the case of *Venus Records and Tapes Pvt. Ltd.* on this issue has been accepted and the aforesaid disputed issue has not been further contested.

Consequently, it is clarified that Rule 9A does not apply to abandoned feature films and that the expenditure incurred on such abandoned feature films is **not** to be treated as a capital expenditure. The cost of production of an abandoned feature film is to be treated as revenue expenditure and allowed as per the provisions of section 37 of the Income-tax Act, 1961.

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Part II: Judicial Update – Direct Tax Laws

Significant Legal Decisions

Residential Status and Scope of Total Income

1. **Can consideration for supply of software embedded in hardware tantamount to 'royalty' under section 9(1)(vi)?**

CIT v. Alcatel Lucent Canada (2015) 372 ITR 476 (Del)

Facts of the case: The assessee, a company incorporated in France, was engaged in manufacture, trade and supply equipment and services for GSM Cellular Radio Telephones Systems. It supplied hardware and software to various entities in India. Software licensed by the assessee embodied the process which is required to control and manage the specific set of activities involved in the business use of its customers. Software also made available the process to its customers, who used it to carry out their business activities. The Assessing Officer contended that the consideration for supply of software embedded in hardware is 'royalty' under section 9(1)(vi).

Appellate Authorities' Views: The Commissioner (Appeals) and Tribunal held that the consideration for supply of embedded software (which is part of the hardware supplied to the assessee customers) did not constitute royalty and therefore, section 9(1)(vi) was not attracted.

High Court's Observations: The High Court, at the outset, noted that the Tribunal had relied upon the precedent in the case of *DIT v. Ericsson A.B. (2012) 343 ITR 470 (Del)*, where the High Court observed that what was sold by the assessee to its Indian customers was a GSM which consisted of both hardware and software. The High Court had also observed that -

(i) the software that was loaded on the hardware did not have any independent existence;

(ii) the software supply is an integral part of GSM mobile telephone system and is used by the cellular operators for providing cellular services to its customers;

(iii) the software is embedded in the system and there could not be any independent use of such software;

(iv) this software merely facilitates the functioning of the equipment and is an integral part of the hardware.

Further, the High Court had also referred the decision of the Apex Court in Tata Consultancy Services v. State of Andhra Pradesh (2004) 271 ITR 401, wherein it was held that software incorporated on a media would be goods liable to sales tax.

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<u>High Court's Decision:</u> The High Court concurred with the decision of the Tribunal holding that where payment is made for hardware in which the software is embedded and the software does not have independent functional existence, no amount could be attributed as 'royalty' for software in terms of section 9(1)(vi).

<u>Incomes which do not form part of total income</u>

2. **Where an institution engaged in imparting education incidentally makes profit, would it lead to an inference that it ceases to exist solely for educational purposes?**

Queen's Educational Society v. CIT (2015) 372 ITR 699 (SC)

<u>Facts of the case</u>: The assessee, an educational institution, showed a net surplus of ₹ 6.59 lakhs and ₹ 7.83 lakhs, respectively, for the assessment years 2000-01 and 2001-02. Since it was established with the sole object of imparting education, it claimed exemption under section 10(23C)(iiiad). The Assessing Officer rejected the claim of exemption on the ground that the assessee has made profits and did not exist solely for educational purposes. The Commissioner (Appeals) allowed the assessee's claim and the Tribunal dismissed the Revenue's appeal holding that the assessee was engaged undoubtedly in imparting education and the profit was only incidental to the main object of spreading education. However, the High Court restored the order of the Assessing Officer on the reasoning that the institution made profit, year on year, and hence, was not eligible for tax exemption.

<u>Supreme Court's Observations</u>: The Supreme Court observed that the provisions of section 10(23C)(iiiad) provide for three requirements, namely,

(i) the education institution must exist solely for educational purposes;

(ii) it should not be for purposes of profit; and

(iii) the aggregate annual receipts of such institution should not exceed the amount as may be prescribed. Such monetary limit is ₹ 1 crore as per Rule 2BC.

The Supreme Court concurred with the Tribunal's reasoning that profit is only incidental to the main object of spreading education. If there is no surplus arising out of the difference between receipts and outgoings, the trust will not be able to achieve the objectives. Any education institution cannot be run in rented premises for all the times and without necessary equipment and without paying to the staff engaged in imparting education. The assessee is not getting any financial aid/assistance from the Government or other philanthropic agency and, therefore, to achieve the objective, it has to raise its own funds. However, such surplus would not come within the ambit of denying exemption under section 10(23C)(iiiad).

Further, the Apex Court made reference to the tests culled out in its own decisions in the case of *Addl. CIT v. Surat Art Silk Cloth Manufacturers Association [1980] 121 ITR 1,*

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Aditanar Educational Institution v. Addl. CIT [1997] 224 ITR 310 and American Hotel and Lodging Association Educational Institute v. CBDT [2008] 301 ITR 86, which would apply for determining whether an educational institution exists solely for education purposes and not for purposes of profit.

The Apex Court, after analyzing the legal provisions and precedents, summed up the law common to section 10(23C)(iiiad)/(vi):

(a) Where an educational institution carries on the activity of education primarily for educating persons, the fact that it makes a surplus does not lead to the conclusion that it ceases to exist solely for educational purposes and becomes an institution for the purpose of making profit;

(b) The predominant object test must be applied – the purpose of education should not be submerged by a profit making motive;

(c) A distinction must be drawn between the making of surplus and an institution being carried on "for profit". Merely because imparting of education results in making a profit, it cannot be inferred that it becomes an activity for profit;

(d) If after meeting expenditure, surplus arises incidentally from the activity carried on by the educational institution, it will not cease to be one existing solely for educational purposes; and

(e) The ultimate test is whether on an overall view of the matter in the concerned assessment year, the object is to make profit as opposed to educating persons.

Apex Court's Decision: Based on the above principles and tests, the Apex Court upheld the Tribunal's view that the assessee was engaged in imparting education and the profit was only incidental to the main object of spreading education. Hence, it satisfies the conditions laid down in section 10(23C)(iiiad) for claim of exemption thereunder.

Profits and gains from business or profession

3. Under what head of income should income from letting out of godowns and provision of warehousing services be subject to tax - "Income from house property" or "profits and gains of business or profession"?

CIT v. NDR Warehousing P Ltd (2015) 372 ITR 690 (Mad)

Facts of the case: The assessee engaged in the business of warehousing, handling and transport business claimed income from letting out of buildings and godowns as business income. The Assessing Officer assessed such income as "Income from house property".

Appellate Authorities' Observations: The Commissioner (Appeals) observed that the assessee's activity was not merely letting out of warehouses but storage of goods with provision of several auxiliary services such as pest control, rodent control and fumigation service to prevent the goods stored from being affected by vagaries of moisture and

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temperature. Further, service of security and protection was also provided to the goods stored. There is, therefore, no dispute that the assessee carries on the activity in an organised manner. These activities are more than mere letting out of the godown for tenancy.

The Tribunal noted that the objects clause of the memorandum of association of the company clearly shows that the assessee-company was incorporated with the object of carrying on the business of warehousing and letting/renting of godowns and providing facilities for storage of articles or things and descriptions whatsoever. The profit and loss account of the assessee-company shows that its main source of income is storage charges and maintenance or user charges. Even substantial part of the expenses also relate to the salaries of employees engaged in the maintenance and upkeep of the godowns and warehouses. Based on these facts, Tribunal concurred with the findings of the Commissioner (Appeals) and held that the income of the assessee from letting out of warehouses and godowns is chargeable under the head "Profits and gains of business or profession" and not "Income from house property".

High Court's Decision : The High Court observed that the Commissioner (Appeals) as well as the Tribunal had not only gone into the objects clause of the memorandum of the assessee but also individual aspects of the business to come to the conclusion that it was a case of warehousing business, and, therefore, the income would fall under the head "Profits and gains of business or profession".

Accordingly, the High Court held that the income earned by the assessee from letting out of godowns and provision of warehousing services is chargeable to tax under the head "Profits and gains of business or profession" and not under the head "Income from house property".

4. **Can section 41(1) be invoked in respect of long standing credit balances of sundry creditors admitted as liability in the Balance Sheet?**

Principal CIT v. Matruprasad C.Pandey (2015) 377 ITR 363 (Guj)

Facts of the case: A notice under section 142(1) was served upon the assessee along with a detailed questionnaire. On verification of the Balance Sheet, the Assessing Officer noticed that the assessee had shown sundry creditors amounting to ₹197.73 lakhs in the Balance Sheet, for which the assessee was asked to furnish a copy of the ledger account of the last three years, break-up of the amounts outstanding along with complete name, address, PAN and confirmation letters. The assessee failed to produce the break-up of the amounts appearing in the Balance Sheet and therefore, a show cause notice was issued as to why the amounts should not be added to his total income as unexplained credit. The Assessing Officer further observed that in this case, the outstanding liabilities of ten sundry creditors, who were very old, was ₹ 56.52 lakhs and the payment has reached the stage of cessation. Consequently, the Assessing Officer treated the long standing creditors as no longer payable/cessation of liabilities under section 41(1) and

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hence, added such amount to the total income by invoking the provisions of section 41(1).

Appellate Authorities' Views: The Commisioner (Appeals) confirmed the addition of ₹ 56.52 lakhs by invoking section 41(1). However, the Appellate Tribunal deleted such addition in respect of outstanding credit balances of certain parties brought forward from earlier years by invoking section 41(1).

High Court's Observations: The High Court observed that the Assessing Officer invoked section 41(1) by doubting certain creditors which were appearing in the balance sheet for the past several years. At no point of time earlier, the Assessing Officer doubted the credit worthiness or identity of the creditors.

The Court referred the decision of its own division bench in the case of *CIT v. Nitin S.Garg (2012) 22 taxmann.com 59* wherein it was observed that where the assessee had continued to show the admitted amounts as liabilities in its Balance Sheet and no interest had been paid on those loans, section 41(1) cannot be invoked merely because they were outstanding for the last so many years. The Division Bench noted that the Assessing Officer shall have to prove that the assessee has obtained the benefits in respect of such trading liabilities by way of remission or cessation thereof.

High Court's Decision : The High Court held that addition on the ground that the amounts were outstanding for several years cannot be made under section 41(1) unless and until it is found that there was remission or cessation of liability that too during the previous year, relevant to the assessment year in question. Even if the credit balances are outstanding for long time, such balances cannot be subjected to tax by invoking section 41(1), unless there is a remission/cessation of liability in the year under question.

5. **Where the lump sum amount paid as One Time Settlement (OTS), without bifurcation of interest and principal, has been offered to tax under section 41(1), can the assesseee claim benefit of deduction of interest (interest paid plus interest waived) under section 43B?**

CIT v. KLN Agrotechs (P) Ltd (2015) 375 ITR 301 (Kar.)

Facts of the case: The assessee company is engaged in the business of manufacture and trading of refined edible oil. It had taken working capital loan from Canara Bank aggregating to ₹ 441.30 lakhs. Due to default in repayment of loan, the bank declared the account as NPA. The total outstanding payable by the company was ₹ 635.26 lakhs which included principal amount of ₹ 441.30 and interest amount of ₹ 193.96 lakhs. During the assessment year in question, the assessee arrived at One Time Settlement (OTS) scheme with the bank. As per the OTS, the assessee paid ₹ 378.72 lakhs (against the total outstanding of ₹ 635.26 lakhs) to the bank.

In the return filed, the assessee offered as income ₹ 256.54 lakhs being the difference between the amount outstanding (₹ 635.26 lakhs) and the actual amount paid

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(₹ 378.72 lakhs). The assessee also claimed the interest of ₹193.96 lakhs as deduction under section 43B.

The Revenue rejected the claim of deduction under section 43B in respect of ₹ 193.96 lakhs and charged to tax the entire amount of ₹ 256.54 lakhs considering the actual amount paid as the amount adjusted towards the principal outstanding amount.

Appellate Tribunal's view: The Appellate Tribunal, however, allowed the claim of the assessee holding that the assessee cannot be subjected to double jeopardy i.e., it could not be subjected to tax on the entire waived amount as well as subjected to disallowance of interest under section 43B, as the said two effects are mutually exclusive and cannot co-exist.

High Court's Observations & Decision : The High Court concurred with the Tribunal's view that if out of the total sum of ₹ 256.54 lakhs which has been offered and subjected to tax by the assessee in its return, the amount of unpaid interest of ₹ 193.96 lakhs is deducted then the waived principal sum would come to ₹ 62.58 lakhs (i.e., ₹441.30 lakhs *minus* ₹ 378.72 lakhs), which is the amount which ought to have been taxed under section 41(1).

Based on the above reasoning, the High Court held that either the interest amount has to be allowed as deduction under section 43B or the sum offered for tax (as waived by the bank) has to be reduced by the amount of interest. In either case, the effective amount which is subjected to tax, would come to the same.

Note *- The rationale of the Karnataka High Court ruling in the above case can be explained with the help of a simple example:*

The following are particulars of OTS scheme of A Ltd. with ABC Bank -

	Particulars	*Principal*	*Interest*	*Total*
		₹ in lakhs		*₹ in lakhs*
(1)	***Amount Outstanding (Working Capital loan)***	***400***	***150***	***550***
(2)	***Payment under OTS scheme with bank***			*300*
	Option 1	*150*	*150*	
	Option 2	*300*	*-*	
	Option 3	*200*	*100*	
(3)	***Waiver [(1) – (2)]***			*250*
	Option 1	*250*	*-*	
	Option 2	*100*	*150*	
	Option 3	*200*	*50*	

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In all three cases above, let us assume that A Ltd. has offered ₹ 250 lakhs (i.e., ₹ 550 lakhs - ₹ 300 lakhs) as income under section 41(1) and claimed the interest paid/waived as deduction under section 43B.

*In **Option 1**, A Ltd. has rightly offered ₹ 250 lakhs, being waiver of principal amount, as income under section 41(1). In this case, the interest of ₹ 150 lakhs actually paid would be deductible under section 43B on payment basis.*

*In **Option 2**, A Ltd. should have offered only ₹ 100 lakhs, being waiver of principal amount, as income under section 41(1). However, it has offered the entire amount of ₹ 250 lakhs waived, as income under section 41(1). Therefore, A Ltd.'s claim of ₹ 150 lakhs, being interest waiver, as deduction under section 43B would result in effectively bringing to tax the principal waiver of ₹ 100 lakhs.*

*In **Option 3**, A Ltd. should have offered only ₹ 200 lakhs, being waiver of principal amount, as income under section 41(1) and claimed interest of ₹ 100 lakhs paid as deduction under section 43B. However, A Ltd. has offered the entire amount of ₹ 250 lakhs waived, as income under section 41(1). Therefore, A Ltd. claim for deduction of ₹ 150 lakhs [₹ 100 lakhs, being interest paid + ₹ 50 lakhs, being interest waived] under section 43B would effectively bring to tax the principal waiver of ₹ 200 lakhs.*

This, in effect, is the rationale of the court ruling, i.e., where the entire amount waived has been offered as income under section 41(1), the claim of interest waived and interest paid as deduction under section 43B would effectively bring to tax, the principal amount waived.

Capital Gains

6. Can advance given for purchase of land, building, plant and machinery tantamount to utilization of capital gain for purchase and acquisition of new machinery or plant and building or land, for claim of exemption under section 54G?

Fibre Boards (P) Ltd v. CIT (2015) 376 ITR 596 (SC)

Facts of the case: The assessee-company had an industrial unit in Thane, which had been declared a notified urban area by notification dated September 22, 1967, issued under section 280Y(d) of the Income-tax Act, 1961 *vide* Notification dated 22.09.1967. The assessee, in order to shift its industrial undertaking from an urban area to a non-urban area, sold its land, building and plant and machinery situated at Thane and out of the capital gains so earned, paid advances of various amounts to different persons for purchase of land, plant and machinery, construction of factory and building in the year 1991-92. The assessee claimed exemption under section 54G of the Income-tax Act, 1961, on the capital gains earned from the sale proceeds of its erstwhile industrial undertaking situated in Thane in view of the advances so made, which was more than the capital gains earned by it. The Assessing Officer refused to grant exemption to the assessee under section 54G on the ground that the non-urban area had not been

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declared to be so by any general or special order of the Central Government and that giving advances did not amount to utilisation of capital gains for acquiring the assets.

Appellate Authorities' views: The CIT (Appeals) dismissed the case of the assessee while the Appellate Tribunal allowed the appeal by stating that even an agreement to purchase is good enough and that Explanation to section 54G is declaratory in nature and would be retrospectively applicable.

High Court's Decision: The High Court reversed the order of the Appellate Tribunal and denied the exemption on the reasoning that the notification declaring Thane to be an urban area stood repealed with the repeal of the section under which it was made. Further the expression "purchase" in the section 54G cannot be equated with the expression "towards purchase" and accordingly the advance for purchase of land, plant and machinery would not entitle the assessee to claim exemption under section 54G.

Supreme Court's Observations: The Apex Court observed that, on a conjoint reading of the Speech of the Finance Minister introducing the Finance Bill, 1987, and the Notes on Clauses and Memorandum explaining the provisions of the Finance Bill of 1987, it becomes clear that the idea of omitting section 280ZA of the Income-tax Act, 1961 and introducing section 54G on the same date was to do away with the tax credit certificates scheme together with the prior approval required by the Board and to substitute the repealed provision with the new scheme contained in section 54G. Once section 280ZA was omitted from the statute book, section 280Y(d) having no independent existence would for all practical purposes also cease to exist. Section 280Y(d) which was a definition section defining "urban area" for the purpose of section 280ZA alone was also omitted subsequently by the Finance Act, 1990. Apart from this, section 54G(1) by its *Explanation* introduces the very definition contained in section 280Y(d) in the same terms. It is obvious that both provisions are not expected to be applied simultaneously and it is clear that the *Explanation* to section 54G(1) repeals, by implication, section 280Y(d).

Unlike section 6 of the General Clauses Act, 1897 which saves certain rights, section 24 merely continues notifications, orders, schemes, rules, etc., that are made under a Central Act which is repealed and re-enacted with or without modification. The idea of section 24 of the 1897 Act is, as its marginal note shows, to continue uninterrupted subordinate legislation that may be made under a Central Act that is repealed and re-enacted with or without modification.

Section 54G gives a time limit of 3 years after the date of transfer of capital asset in the case of shifting of industrial undertaking from urban area to any area other than urban area. The expression used in section 54G(2) is that the amount "which is not utilized by him for all or any of the purposes aforesaid has to be deposited in the capital gain account scheme".

For the purpose of availing exemption, all that was required for the assessee is to "utilise" the amount of capital gain for purchase and acquisition of new machinery or plant

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and building or land. Since the entire amount of capital gain, in this case, was utilized by the assessee by way of advance for acquisition of land, building, plant and machinery, the assessee was entitled to avail exemption/deduction under section 54G.

Supreme Court's Decision :To avail exemption under section 54G in respect of capital gain arising from transfer of capital assets in the case of shifting of industrial undertaking from urban area to non-urban area, the requirement is satisfied if the capital gain is given as advance for acquisition of capital assets such as land, building and / or plant and machinery.

Note *– In this case, two issues have been touched upon, namely, whether notification of an area as an urban area under a repealed provision would hold good under the re-enacted provision and whether advance given for purchase of an eligible asset would tantamount to utilisation of capital gains for purchase of the said asset for availing exemption under section 54G. The former issue was decided taking support from section 24 of the General Clauses Act, 1897, which provides for uninterrupted subordinate legislation in case of repeal and re-enactment, with or without modification. The latter issue was also decided in favour of the assessee by holding that payment of advance for purchase of eligible asset would tantamount to utilisation of capital gains for purchase of the said asset.*

7. Whether, for the purpose of computing the period of holding of the property, the date of allotment letter issued by the builder of the flat or the date of registration of the property has to be considered for determining the nature of capital asset – long-term or short-term?

CIT v. S.R.Jeyashankar (2015) 373 ITR 120 (Mad)

Facts of the case: In the present case, the assessee had entered into an agreement with M/s Vishranthi Homes Pvt. Ltd.(VHPL) for purchase of undivided share in a piece of land as well as for construction of a flat under a project promoted by the said builder *vide* agreement dated February 22, 2005. Over a period of time, the payments were made and the transaction was concluded with registration of undivided share of land on August 4, 2005. Thereafter, the assessee sold the entire unit by a sale deed dated April 10, 2008, well after 36 months from the date of agreement i.e., February 22, 2005, and claimed the difference between the sale consideration and the indexed cost of acquisition as long-term capital gains. The Assessing Officer, however, took a view that the undivided share of land was registered on August 4, 2005, and since the property was purchased in the month of August, 2005, and sold in April, 2008, the capital gains arising from sale will be assessed as short-term capital gains only and, accordingly, the Assessing Officer denied benefit of section 2(29A) of the Income-tax Act, 1961 and made addition.

Appellate Authorities' Views: The Commissioner (Appeals) placed reliance on Circular No.471 dated 15.10.1986 and allowed the claim of the assessee. The Tribunal, after

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taking into consideration the decisions of the Punjab and Haryana High Court, in the cases of *Mrs. Madhu Kaul v. CIT [2014] 363 ITR 54 and Vinod Kumar Jain v. CIT [2012] 344 ITR 501 a*nd Circular No. 471, dated 15.10.1986, held that the date of allotment of the flat has to be adopted as date of acquisition of the immovable property when it comes to acquiring a flat from the promoter of the flat by way of executing construction agreement and not the date of the sale deed for purchase of the undivided share in land. Accordingly, the Tribunal confirmed the order of the Commissioner (Appeals).

High Court's Observations: The Madras High Court noted that the Tribunal had relied on the decision of the Punjab and Haryana High Court in *Mrs. Madhu Kaul's case,* where it was held that the date of allotment under a scheme framed by the DDA is to be taken as the date of acquisition and the mere fact that the actual possession was delivered later does not distract the fact that the allottee was conferred a right to hold the property on issuance of allotment letter and the payment of balance instalments, identification of a particular flat and delivery of possession are consequential acts that relate back to and arise from the date rights were conferred by the allotment letter. In effect, the Punjab & Haryana High Court held that the allottee gets the title to the property on issuance of allotment letter and payment in instalments is only a consequential act upon which delivery of possession to the property flows. The Madras High Court also noted that the Punjab & Haryana High Court had taken a similar view in *Vinod Kumar Jain's* case.

In this case, the Madras High Court observed that the right to the property flows from the date of agreement with the builder i.e., from February, 2005. Over a period of time, payments were made and the transaction was concluded in accordance with the terms of the agreement by registering the undivided share in land and handing over of the flat subsequently.

High Court's Decision: Accordingly, the Madras High Court held that the assessee had rightly claimed the benefit of long-term capital gain, since the holding period exceeded 36 months (i.e., from 22.02.2005, being the date of agreement, to 10.04.2008, being the date of sale of property).

Deductions from Gross Total Income

8. **Can the Commissioner reject an application for grant of approval under section 80G(5) on the ground that the trust has failed to apply 85% of its income for charitable purposes?**

CIT v. Shree Govindbhai Jethalal Nathavani Charitable Trust (2015) 373 ITR 619 (Guj)

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Facts of the case: The assessee trust filed an application in Form 10G for grant of approval under section 80G(5)[1]. It also filed copies of trust deed and registration certificate dated 18th August, 2011 with the approving authority. As per the trust deed, the main objects of the trust are educational, social activities, etc. In order to verify the facts stated in the application, the trust was asked to produce books of account, relevant vouchers, donation book and minutes in original. On perusal of the books for financial year 2011-12, it was found that the trust had not applied 85% of its income and therefore, the Commissioner rejected the application of the assessee seeking approval under section 80G(5) and Rule 11AA of the Income-tax Rules, 1962.

Tribunal's view: On appeal, the Tribunal noted the decision of Punjab and Haryana High Court in the case of *CIT v. O.P. Jindal Global University (2013) 38 Taxmann 366*, in which it was held that at the time of granting approval of exemption under section 80G, only the objects of the trust are required to be examined and the aspect of application of funds can be examined by the Assessing Officer at the time of framing the assessment. Consequently, the Tribunal held that the Commissioner has erred in refusing to grant recognition to the trust under section 80G(5).

High Court's Observations: The High Court was of the view that the issue in the present case is now not *res integra* in view of the decision of the Division Bench of this Court in the case of *N.N.Desai Charitable Trust v. CIT (2000) 246 ITR 452 (Guj).* In that case, the Division Bench observed that, while considering the application for the purpose of section 80G, the authority cannot act as an assessing authority and the enquiry should be confined to finding out if the institution satisfies the prescribed conditions. The Division Bench also made the following observations:

(i) Section 80G does not relate to assessment of the trust or the institution whose income is not liable to be included in the computation of taxable income under various provisions of the Act. Primarily, section 80G is related to giving deduction in respect of donations made by a person to such trusts and institutions.

(ii) There are two distinct concepts. The first is whether an institution or fund is such whose income is not liable to be included in the computation of total income, has to be determined on the basis of its status or character. The second is the actual assessment of income, which necessarily takes place in future after donation is received by the donee, on fulfilment of other conditions about application of income by the eligible trusts, which in the very nature of things can operate only after receipt of income. The two are different concepts.

[1] Section 80G(5)(i) provides that donation to any institution or fund would qualify for deduction thereunder only if it is established in India for a charitable purpose and derives such income which would not be liable to inclusion in its total income under the provisions of sections 11 and 12 or section 10(23AA)/(23C).

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(iii) The liability to assessment is neither affected on account of grant of recognition under section 80G nor on whether the donor ultimately gets deduction in respect of such donation. Once a trust is registered under section 12AA, its income from property includes donation which is covered by section 11(1)(d) or under section 12. Such donations are deemed to be income from property, which are not to be included in the total income under section 11 or section 12. The enquiry under section 80G, hence, cannot go beyond that.

(iv) The scope of enquiry cannot include an enquiry as to whether, at the close of the previous year, the donee-trust will actually be able to apply 85% of its income because non-fulfillment of some conditions by the donee-trust as regards application or accumulation cannot be ascertained *in praesenti*, when the donation is made. The question of whether the trust will be able to apply 85% of its income can be determined only from the facts existing at the close of the assessment year.

The High Court also noted that similar views were expressed by the Punjab and Haryana High Court in the case of *CIT v. O. P. Jindal Global University (2013) 38 Taxmann.com 366.*

High Court's Decision: The High Court, thus, concurred with the decision of the Tribunal setting aside the order passed by the Commissioner refusing to grant registration under section 80G(5) to the assessee-trust due to the reason that it has not applied 85% of its income for charitable purposes.

Assessment Procedure

9. **Can a notice under section 148 for a particular assessment year be issued solely on the ground that survey under section 133A was carried on at the business premises of the assessee, where nothing had been found therein which would indicate escapement of income chargeable to tax for the said assessment year?**

Hemant Traders v. ITO (2015) 375 ITR 167 (Bom)

Facts of the case: In the present case, the assessee is a partnership firm and registered as a Commission agent of the onion potato market under the Agricultural Produce Market, Committee, Navi Mumbai. The firm is regularly assessed to income-tax. The firm filed a return of income for A.Y.2010-11 on October 14, 2010 along with audit report, audited Balance Sheet and Profit & Loss Account for the year ended 31.3.2010. The return was processed and intimation under section 143(1) was issued on 20.02.2012, seeking clarification. No assessment order was passed. The assessee claimed that the profit as per the return of income was accepted. Meanwhile, a survey under section 133A was carried out at the business premises of the assessee on 7th January 2011 pertaining to A.Y. 2011-12. However, the survey party did not find any discrepancy in the books of account. Further, the survey report did not contain any reference to any transactions for

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A.Y. 2010-11. In March 2014, the assessee was issued a notice under section 148 for the A.Y. 2010-11 based on the said survey.

The assessee preferred a writ challenging the issue of notice on the reasoning that no satisfaction was recorded of the escapement of income in the survey report or in any other relevant material. *Ex-facie,* the reassessment was bad in law.

High Court's Observations: The High Court perused the survey report which recorded that there was a group of assessees who were engaged in wholesale trading of potato on commission basis. The survey was conducted based on the allegations that these parties were resorting to hoarding of potatoes and making huge profits by fluctuating the day-to-day price of potatoes in the market. During survey, the assessee's books of account, cash balance and stocks were physically verified and inventory prepared. The report revealed cash difference of ₹ 5,020 and the explanation given was that the same pertained to the day-to-day and miscellaneous expenditure incurred on the day of survey. The report also revealed physical stock difference of 672 bags of potatoes. The explanation for such difference was recorded.

Neither the survey report nor any other material indicated escapement of income chargeable to tax for A.Y. 2010-11. The Assessing Officer had nothing before him to record his belief or satisfaction that escapement of income had taken place.

Merely because survey had taken place cannot be a ground for reopening the assessment without valid material or evidence at the time of issue of notice. Whenever there was shortage of potatoes in the market, such powers of survey were invoked. Where nothing has been found during the survey operations to indicate that income chargeable to tax has escaped assessment, then the survey report ought not to be the basis for reopening of assessment. Something more was required in law for the Assessing Officer to exercise his powers.

High Court Decision: The High Court, accordingly, held that since there is absolutely no material to indicate escapement of income for the relevant assessment year, the issue of notice to initiate reassessment proceedings under section 148 on the basis of survey which had taken place is not valid. Therefore, the proceedings initiated under section 148 are quashed at the threshold itself.

10. **Will the subsequent amendment of law with retrospective effect validate a reassessment notice issued on a different ground before the retrospective amendment was made?**

Godrej Industries Ltd v. B.S.Singh Dy.CIT (2015) 377 ITR 1 (Bom)

Facts of the case: The assessee-company filed its return of income for the assessment year 2000-01 declaring total income as 'Nil' and a book profit of ₹ 52.70 crores. This resulted in 'book profit' being assessed to income-tax. Later, the Assessing Officer issued notice under section 148 for the reason that income chargeable to tax had

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escaped assessment on the ground that the provision for doubtful debts and provision for depletion of long-term investment debited to the profit and loss account were unascertained liabilities and, hence, in terms of clause (c) of the *Explanation* to section 115JA, i.e., they were to be added back to the net profit for arriving at the book profits.

The assessee preferred a writ challenging the maintainability of the notice issued under section 148.

Revenue's Contention: The Revenue contended that at the time of issuing the impugned notice on March 29, 2007, the position was not clear. The position became clear only when Parliament introduced/added clause (g) to the *Explanation* to section 115JA of the Act with retrospective effect from April 1, 1998, and which reads as under:

"(g) the amount or amounts set aside as provision for diminution in the value of any asset."

Thus, the Revenue submitted that the impugned notice is sustainable on the basis of above clause (g) of the *Explanation* to section 115JA, inserted by the Finance (No.2) Act, 2009 retrospectively with effect from 1st April, 1998.

High Court's Observations: The High Court observed that an identical issue had come up in *Rallis India Ltd. v. Asst. CIT [2010] 323 ITR 54 (Bom)* wherein a reopening notice was, *inter alia*, issued on the ground that the book profits have to be increased by the provision made for doubtful debts and for diminution in the value of investment in view of clause (c) of the *Explanation* to section 115JB. In the said case, the High Court recorded the fact that the Apex Court had, in *CIT v. HCL Comnet Systems and Services Ltd. [2008] 305 ITR 409*, held that the provision for doubtful debts is a provision made for diminution in the value of assets and is not a liability. Thus, it would not fall under clause (c) of the *Explanation* to section 115JA of the Act. Consequent to the aforesaid decision of the Apex Court, the Parliament has amended the *Explanation* both under section 115JA as well as section 115JB of the Act in 2009 by adding clause (g) and clause (i) with retrospective effect from April 1, 1998, and April 1, 2001, respectively. The Court held that though the amendment was made with the retrospective effect, the critical date is the date on which the Assessing Officer exercises jurisdiction under section 148 of the Act and the subsequent amendment could not have been and is in fact not a ground on which the Assessing Officer sought to reopen the assessment. It was held that the validity of a reopening notice of Assessing Officer is to be determined with reference to the reasons which are recorded in support of thereof and nothing else.

In this case also, it is clear that the reasons stated for reopening the assessment are that provision for doubtful debts and depletion in value of investments are both amounts set aside for meeting liabilities other than ascertained liabilities and hence, constitute income escaping assessment. The reasons recorded are not valid as the said items were not related to liabilities as perceived by the Assessing Officer. These provisions are made to take care of the likely fall in the value of assets.

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The High Court observed that it is the Assessing Officer's belief at the time of issuing the reassessment notice that determines the validity of the notice. In this case, he wanted to apply clause (c) of the *Explanation* to section 115JA and whereas the issues got covered by subsequent amendment by means of insertion of clause (g) to the *Explanation* to section115JA by the Finance (No.2) Act, 2009 with retrospective effect from 1.4.1998. The subsequent event could not put life into the Assessing Officer's reason that income chargeable to tax had escaped assessment when the reasons as originally recorded are still born.

High Court's Decision: The position of law on the date of issue of notice under section 148 must be looked into and the retrospective amendment subsequent to issue of notice could not validate a notice issued earlier. It could only amount to change of opinion and the notice for reopening of assessment would become unsustainable.

The High Court, accordingly, allowed the writ and held that the reason for reopening the assessment cannot get validated by the retrospective amendment of law.

Note *– It may be noted that section 115JA levying MAT was applicable from A.Y.1997-98 to A.Y.2000-01. From A.Y.2001-02, MAT is attracted under section 115JB. Clause (c) of Explanation 1 to section 115JB requires addition of amount set aside to provisions made for meeting liabilities, other than ascertained liabilities, to the net profit for arriving at the book profit for levy of MAT. Clause (i) was inserted by the Finance (No.2) Act, 2009 retrospectively with effect from 1st April, 2001 providing for addition of amount set aside as provision for diminution in the value of any asset, to the net profit for arriving at the book profit for levy of MAT. The rationale of the above ruling would, therefore, also apply in the context of examining the validity of notice issued for reopening an assessment on the basis of clause (c) of Explanation 1 to section 115JB, consequent to subsequent retrospective insertion of clause (i) in Explanation 1 to section 115JB.*

11. Can the Assessing Officer make a reassessment on fresh grounds when the original reasons recorded for reopening the assessment does not survive?

N. Govindaraju v. ITO (2015) 377 ITR 243 (Kar)

Facts of the case: The assessee, an individual, deriving income from house property, transport business, capital gains and other sources filed his return of income declaring total income of ₹ 4.82 lakhs and agricultural income of ₹ 1.62 lakhs. The return was processed under section 143(1). Subsequently, a notice under section 148 was issued stating that the assessee had converted agricultural land into non-agricultural purposes, formed sites and sold the same but while arriving at the indexation benefit it was taken up to the date of sale instead of the date of conversion as per section 45(2). Thus, the reason for reassessment was the excessive indexation benefit availed by the assessee. However, in reassessment, the Assessing Officer adopted fair market value which was less than what was adopted by the assessee and also sought to disallow 50% of the

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expenses incurred on transfer. The original reason which prompted the reassessment was dropped and based on fresh grounds, reassessment was completed.

Issue under consideration: One of the issues under consideration before the High Court was whether the reassessment based on fresh grounds would be valid when the original reason which prompted the reassessment, does not survive.

Assessee's contention *vis-s-vis* Revenue's contention: The assessee contended that the reason for which notice was issued has to survive and it is only thereafter that "any other income" which is found to have escaped assessment can also be assessed or reassessed in such proceeding. On the other hand, the Revenue claimed that section 147 is in two parts which have to be read independently; the phrase "such income" in the first part is with regard to reasons which have been recorded and the phrase "any other income" is with regard to cases where no reasons are recorded in the notice but they come to the notice of the Assessing Officer during the course of reassessment proceeding. Both being independent, once the satisfaction in the notice is found sufficient, addition can be made on all grounds i.e., for reasons which have been recorded and also for items for which no reasons were recorded. All that is necessary is that, during the course of the proceedings under section 147, income chargeable to tax must have escaped assessment.

High Court's Observations: The High Court observed that the controversy revolved around *Explanation 3* to section 147 inserted by the Finance (No.2) Act 2009 retrospectively with effect from 1.4.1989. The Court took note of Circular No.5/2010 issued by CBDT after the amendment in Paragraph 47 with caption 'Clarificatory amendment in respect of reassessment proceeding under section 147". Para 47.3 reads as under:

"Therefore, to articulate the legislative intention clearly *Explanation 3* has been inserted in section 147 to provide that the Assessing Officer may examine, assess or reassess any issue relevant to income which comes to his notice subsequently in the course of proceedings under this section, notwithstanding that the reason for such issue has not been included in the reasons recorded under section 148(2)".

The High Court observed that it is true that if the foundation goes, then, the structure cannot remain. Meaning thereby, if notice has no sufficient reason or is invalid, no proceedings can be initiated. However, this can be verified at the initial stage by challenging the notice. If the notice is challenged and found to be valid, or where the notice is not at all challenged, then, in either case, it cannot be said that notice is invalid. As such, if the notice is valid, then the foundation remains and the proceedings on the basis of such notice can continue. The High Court reiterated that once the proceedings have been initiated on a valid notice, it becomes the duty of the Assessing Officer to levy tax on the entire income (including "any other income") which may have escaped assessment and comes to his notice during the course of the proceedings initiated under section 147.

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<u>High Court's Decision</u>: The High Court held that, in effect, once satisfaction of reasons for the notice is found sufficient i.e. if the notice under section 148(2) is found to be valid, then, the Assessing Officer may do reassessment in respect of any other item of income which may have escaped assessment, even though the original reason for issue of notice under section 148 does not survive.

This decision has dissented from the decisions in the case of *CIT v. Jet Airways (I) Ltd (2011) 331 ITR 236 (Bom); Ranbaxy Laboratories Ltd v. CIT (2011) 336 ITR 136 (Del).*

Note *– In this case, the reassessment on the basis of reasons, which did not form the original reasons to believe, but were subsequently discovered by the Assessing Officer, was held to be valid, even though the original reasons did not survive.*

However, the High Court further delved into the additional grounds, and held that the Tribunal was not justified in arriving at the fair market value of the property in question on 1.4.1981 without considering the material on record, including the valuation report, filed by the assessee. The matter was thus to be remanded to the Assessing Officer for determination of the fair market value of the property in question in accordance with law.

Further, without assigning any reason, the Assessing Officer had disallowed 50% of the total expenditure claimed by the assessee towards transfer and brokerage charges, even when the same had been paid by cheque and the receipt for which was obtained from the broker. When the specific case of the assessee was that heavy brokerage had to be paid because the property was under litigation and that it was occupied by unauthorised persons for which payment had to be made to get it vacated, disallowance could not be made on the ground that brokerage was generally being paid at the rate of 1-2%. The High Court opined that when the said brokerage was paid by cheque and there was sufficient reason for paying higher brokerage, the entire amount ought to have been allowed and disallowance of 50% was not justified in law.

Thus, in this case, though the High Court upheld that reassessment could be made on fresh grounds even when the original reasons recorded for reopening the assessment did not survive, additions made on the basis of such fresh grounds were turned down by the High Court, since the reasons were not justified to merit such additions.

<u>Appeals and Revision</u>

12. Can mere non-mention or non-discussion of enquiry made by the Assessing Officer in the assessment order justify invoking revisionary jurisdiction under section 263?

CIT v. Krishna Capbox (P) Ltd (2015) 372 ITR 310 (All)

<u>Facts of the case</u>: The assessee filed its return of income declaring total income of ₹ 8.15 lakhs. The return was processed under section 143(1) and later, the case was selected for scrutiny and statutory notice under section 143(2) was issued. During the

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course of scrutiny, the Assessing Officer raised certain queries which were answered by the assessee. The Assessing Officer, after being satisfied with the replies given, completed the assessment by accepting the declared income. Subsequently, the Commissioner invoked revisionary jurisdiction under section 263 by holding that the Assessing Officer had not made enquiry on certain aspects, such as -

(i) Non-verification of source of investment in respect of addition in fixed assets;

(ii) Non-confirmation of sundry creditors by the assessee;

(iii) Non-enquiry of unsecured loan by the Assessing Officer;

(iv) Not obtaining the copy of bank statements;

(v) Non-verification of genuineness of shareholders;

(vi) Deduction of freight paid without deduction of tax at source.

Assessee's contention *vis-a-vis* Revenue's Contention: The assessee contended that all the aspects contested by the Commissioner were enquired by the Assessing Officer. The Revenue took the defence that no enquiry was made by the Assessing Officer in respect of the issues set out in the notice issued under section 263 and hence, revisionary jurisdiction was correctly assumed.

Tribunal's view: The Tribunal noted that all necessary enquiries were made and all the requisite documents were placed in the paper book. Once enquiry was made, mere non-discussion or non-mention in the assessment order cannot lead to the assumption that the Assessing Officer did not apply his mind or that he had not made any enquiry on the subject for invoking section 263.

High Court's Observations: The High Court noted the Bombay's High Court's view in *Cellular Ltd. v. DCIT (2008) 301 ITR 407* that if a query is raised during the assessment proceedings and responded to by the assessee, the mere fact that it is not dealt with in the assessment order would not lead to a conclusion that no mind had been applied to it.

High Court's Decision: The High Court concurred with the decision of the Tribunal and held that since the relevant enquiries and replies are available on 'record' (i.e., the paper book), the Commissioner cannot invoke revisionary jurisdiction merely because there was no mention of such enquiry and verification in the assessment order.

Note *- The Finance Act, 2015 inserted Explanation 2 to section 263(1) to clarify, inter alia, that an order passed by the Assessing Officer shall be deemed to be erroneous in so far as it is prejudicial to the interests of the revenue, if in the opinion of the Principal Commissioner or Commissioner, the order is passed without making inquiries or verification which should have been made.*

The rationale of this ruling would hold good even after insertion of Explanation 2 to section 263(1), since in this case, the Tribunal has recorded a finding of fact that necessary enquiries have been made by the Assessing Officer even though the same

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was not specifically mentioned in the assessment order. Mere non-discussion or non-mention about the enquiry made by the Assessing Officer in the assessment order cannot be a ground for invoking revisionary jurisdiction under section 263.

13. **Can the Commissioner invoke revisionary jurisdiction under section 263, when the subject matter of revision (i.e., whether the manner of allocation of revenue amongst the members of AOP would affect the allowability and/or quantum of deduction under section 80-IB) has been decided by the Commissioner (Appeals) and the same is pending before the Tribunal?**

CIT v. Fortaleza Developers (2015) 374 ITR 510 (Bom)

Facts of the case: The assessee, an Association of Person (AOP) consisting of promoters and builders, was constituted by means of an agreement dated April 29, 2003 between M/s Raviraj Kothari and Co. (RRK) and M/s Sanand Properties Pvt. Ltd. (SPPL). The AOP filed its return of income for the assessment year 2007-08 declaring total income of ₹ 4.14 lakhs after claiming deduction under section 80-IB(10) of ₹ 1454.47 lakhs. The assessment was completed under section 143(3) disallowing fully the claim of deduction under section 80-IB(10). The assessee preferred an appeal before Commissioner (Appeals) who held that the assessee had fulfilled all the conditions laid down in section 80-IB(10) and hence, directed the Assessing Officer to allow the deduction.

The order of Commissioner (Appeals) was challenged before the Tribunal by the Revenue. During the pendency of the appeal before the Tribunal, the Commissioner issued a notice under section 263 asking the assessee to show cause as to why the assessment order should not be set aside. The notice under section 263 specified that the method of allocation of revenue gave the assessee undue benefit by way of a higher claim of deduction under section 80-IB(10) contrary to clause (7) of the AOP agreement.

Clause (7) of the agreement laid down that SPPL shall be entitled to 35% of the amount received from the purchasers of the housing units. Out of the balance 65% of the said receipts, all required and relevant expenditure for the purpose of the business of the AOP shall be met with and whatever net balance remains thereafter, shall be determined as the share of income of RRK.

On perusal of clause (7) of the agreement, the Commissioner contended that share of revenue pertaining to SPPL was not eligible for deduction under section 80-IB(10). Accordingly, the Commissioner set aside the assessment order of the assessee and directed to recompute the income on the basis of the clause (7) of the AOP agreement. The assessee challenged the revision order passed by the Commissioner under section 263 before the Tribunal.

Appellate Authorities' Views: The Tribunal observed that the quantum of deduction under section 80-IB(10) will depend upon the income earned from the project in question. The quantum of deduction will not depend on the mode of distribution of shares amongst

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members of the association of persons as income of association of persons is taxable at the maximum marginal rate. It is also observed by the Tribunal that the allowability or otherwise of deduction under section 80-IB(10) is not dependent upon the manner in which the profit has been distributed amongst the members of the AOP but is dependent upon the income earned from an eligible project and the fulfilment of the conditions laid down in the section. Also, the deduction is available to an undertaking and not to the individual constituent of an undertaking. The Tribunal further held that the Commissioner cannot exercise jurisdiction under section 263 in respect of deduction under section 80-IB, which was the subject matter of appeal.

High Court's Views: The High Court took note of all the facts and sequence of events with regard to the matter in appeal. The Court was of the view that the contract between the two parties was self-explanatory and the interpretation placed by the assessee on clause (7) and claiming deduction under section 80-IB(10) is in order.

High Court's Decision : When the order of the first appellate authority is complete and the appeal is pending before the Tribunal, the Commissioner is precluded from invoking section 263 for revision of the very same matter decided by the first appellate authority since clause (c) of the *Explanation 1* to section 263 debars the same.

Accordingly, the High Court held that the order passed by the Assessing Officer got merged with the order of the first appellate authority. The very same issue cannot be revised by invoking revisionary jurisdiction under section 263.

Deduction, Collection and Recovery of Tax

14. Whether chit dividend paid to subscribers of chit fund is in the nature of 'interest' in terms of section 2(28A) to attract deduction of tax at source under section 194A?

CIT v. Avenue Super Chits (P) Ltd (2015) 375 ITR 76 (Kar)

Facts of the case: The assessee-company engaged in chit fund business had several chit groups which consisted of 25 to 40 customers each. Each subscriber has to subscribe an equal amount based on the value of chit. There are two types of chit. One is the lottery system and other is auction system. Under the auction system, during each instalment of the chit, the highest bidder got the chit amount. The unsuccessful members would earn dividend [chit dividend as defined under section 2(h) of Chit Fund Act, 1982].

Revenue's Contentions: The Revenue contended that when the successful bidder in an auction took the prize money earlier to the period to which he is entitled, he is liable to pay an amount to others who contributed to take the prize money, the amount so paid is nothing but interest which is liable for tax deduction under section 194A. The assessee had failed to do so, and therefore, he is treated as an assessee-in-default under section 201 and is liable to pay interest under section 201(1A).

Appellate Authorities Views : The Commissioner (Appeals) held that the amount paid by way of dividend could not be called as 'interest' in terms of section 2(28A) of the

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Income-tax Act, 1961 and hence, there was no liability on the part of the assessee to deduct tax at source. The Tribunal affirmed the findings of Commissioner (Appeals).

High Court's Observations: The High Court noted the decision of *CIT v. Sahib Chits (Delhi) (P) Ltd (2010) 328 ITR 342 (Del)* wherein section 2(28A) was referred to decide that chit dividend cannot be treated as interest. Further, section 194A has no application to such (chit) dividend and therefore, there is no obligation on the part of the assessee to make any deduction under section 194A before such dividend is paid to the subscribers of the chit.

High Court's Decision : The High Court held that the above judgment squarely applies to the facts of this case. Therefore, auction chit dividend paid to subscribers of the chit is not 'interest' as defined in section 2(28A) of the Income-tax Act, 1961 and therefore, tax deduction in terms of section 194A is not attracted.

Notes:

(1) Meaning of certain terms:

Term	Section	Meaning
Dividend	*2(h) of Chit Fund Act, 1982*	*The share of the subscriber in the amount of discount available under the chit agreement for rateable distribution among the subscribers at each instalment of the chit.*
Discount	*2(g) of the Chit Fund Act, 1982*	*The sum of money or the quantity of grain which a prized subscriber is, under the terms of the chit agreement, required to forego and which is set apart under the said agreement to meet the expenses of running the chit or for distribution among the subscriber or for both.*
Interest	*2(28A) of the Income-tax Act, 1961*	*Interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and includes any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilized.*

(2) Example (to explain the concept of Chit Fund):

Let us suppose 50 persons come together to organise a chit and each of them undertake to contribute ₹ 1,000. The total chit amount would be ₹ 50,000 (₹ 1,000 × 50). Let us further suppose that the fund would operate for a period of 50 months. Thus, the member subscribers and the number of months for which the

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chit would operate would be the same. In this example, at the end of each month, an amount of ₹ 50,000 (₹ 1,000 × 50) would be available in the kitty of the chit fund. The said amount would be put to auction and those subscribers who are interested in drawing the money early because of their needs may participate in the auction. The successful bidder, who is normally the person who offers the highest discount, is given the chit amount.

For example, let us assume that there are three bidders offering to take the chit for ₹ 50,000. They offer ₹ 40,000, ₹ 35,000 and ₹ 33,000, respectively. The chit would be given to that subscriber who is willing to take it for ₹ 33,000, since he has offered a discount of ₹ 17,000. This leaves a balance of ₹ 17,000 in the kitty. The amount of ₹ 17,000 which represents the discount which the successful bidder has foregone becomes the dividend which is to be distributed to the subscribers.

15. **Where remuneration paid to doctors is variable based on number of patients and treatment given to them, would the liability to deduct tax at source arise under section 192 or under section 194J?**

CIT v. Manipal Health Systems (P) Ltd (2015) 375 ITR 509 (Kar)

Facts of the case: The assessee-company is an institution providing health services. A survey under section 133A was conducted on the business premises of the assessee in order to ascertain the TDS compliance. While conducting the survey, the Assessing Officer found that the assessee company has deducted tax on payment made to doctors under section 194J. The Assessing Officer came to a conclusion that there existed an employer-employee relationship between the hospital and the doctors engaged by it, and hence, the assessee was required to deduct tax at source under section 192. Accordingly, the Assessing Officer computed the liability for short deduction of tax at source under section 201(1) and section 201(1A). The assessee challenged the said demand before the Commissioner (Appeals).

Appellate Authorities' Views: The Commissioner (Appeals) allowed the claim holding that the doctors cannot be construed as employees of the assessee-company. The Tribunal dismissed the appeal filed by the Revenue.

High Court's Observations: The High Court observed that to decide whether the relationship of employer-employee existed or not, the contract entered into between the parties has to be seen - whether the same is a **"contract for service"** or a **"contract of service"**. In order to ascertain the nature of contract, multiple-factor tests have to be applied. The independence test, control test, intention test are some of the tests adopted to distinguish between 'contract for service' and 'contract of service'.

The High Court examined the terms of the contract entered into between the asseesee-company and the doctors. As per the said terms,

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- The remuneration paid to the doctors depends on the treatment given to patients and on the number of patients - if the number of patients are more, remuneration would be on a higher side or if no patients, no remuneration;
- The timing of the doctors is fixed; and
- They cannot have private practice or attend any other hospital.

It was observed that mere provision of non-competition clause in the agreement shall not change the nature of contract from profession to that of employment. Imposing a condition of bar to private practice is to make use of the expertise, skill of a doctor exclusively for the assessee-company, i.e., to get the attention and focus of the professional skill and expertise only to the patients of the assessee-company and to discourage doctors from transferring patients to their own clinics or any other hospital. The High Court also noted the Tribunal's finding that none of the doctors are entitled to gratuity, provident fund, leave travel allowance and other terminal benefits. It is also pertinent to note that the doctors have filed their returns of income for the relevant assessment years showing the income received from the assessee-company as professional income and the same is said to have been accepted by the Department.

In *CIT (TDS) v. Apollo Hospitals International Ltd. (2013) 359 ITR 78*, the Gujarat High Court took a view that consultant doctors were not getting salary but payment to them was in the nature of professional fees liable to tax deduction at source under section 194J.

High Court's Decision: Considering the totality of facts and terms of the agreement, the Court held that in this case, the consultancy charges paid to doctors rendering professional service would be subject to tax deduction under section 194J and not section 192.

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PAPER – 8 : INDIRECT TAX LAWS

PART – III : QUESTIONS AND ANSWERS

QUESTIONS

Note: All questions have to be answered on the basis of position of law as amended by the Finance Act, 2015 and Notifications/Circulars issued till 31.10.2015.

Classification of excisable goods

1. "A skin ointment available across the counter shops without the prescription of a medical practitioner should always be classified as a cosmetic and not as a medicament."

   Do you agree with the statement? Reason out your answer by bringing out the principles laid down by the Supreme Court in the case of *Ciens Laboratory* for differentiating between a medicament and a cosmetic/toilet preparation for the purpose of classification under central excise.

CENVAT credit

2. Gauri Manufacturers is engaged in manufacture of product 'X' liable to excise duty @ 12.5%. It also manufactures product 'Y' in respect of which the benefit of an exemption under *Notification No. 1/2011 CE dated 01.03.2011* is availed. In the month of October, 2015, it cleared Product 'X' of assessable value worth ₹ 240 lakh and Product 'Y' of assessable value worth ₹ 80 lakh.

   For manufacturing Product 'X', input 'P' and input 'R' are used while for manufacturing Product 'Y', only input 'R' is used. Duty paid in the said month in respect of input 'P' is ₹ 16 lakh and in respect of input 'R' is ₹ 9.6 lakh.

   Since Gauri Manufacturers does not maintain separate accounts with respect to usage of input 'R' in Product 'X' and Product 'Y', it has opted to avail CENVAT credit under rule 6(3)(i) of CENVAT Credit Rules, 2004.

   You are required to calculate:

   (i) amount payable, if any, under rule 6(3)(i), and

   (ii) central excise duty payable by Gauri Manufacturers for the month of October, 2015 showing separately the duty payable by availing CENVAT credit and duty payable in cash.

   Note: Excise duty @ 2% is payable under *Notification No. 1/2011 CE dated 01.03.2011.* There is no opening balance of CENVAT credit available with Gauri Manufacturers.

Valuation of excisable goods

3. ABC Ltd. is engaged in the manufacture of machines. It has sold a machine to XYZ Ltd. on ex-factory basis. The sale price of the machine (excluding all taxes and duties) is ₹ 8,00,000. Rate of excise duty is 12.5%.

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The above sale price includes the following amounts charged from XYZ Ltd.:

		₹
(i)	Expenses pertaining to installation and erection of the machine at XYZ Ltd.'s premises (Machine was permanently affixed to earth)	30,000
(ii)	Special packing in corrugated boxes for safe transportation of machine	6,000
(iii)	Advertisement and publicity charges	16,000
(iv)	Pre-delivery inspection charges and after sales service charges	22,000
(v)	Warranty charges	28,000

Following additional information is also available:

(i) XYZ Ltd. has been given a trade discount of ₹ 32,000 on the sale price of ₹ 8,00,000.

(ii) XYZ Ltd. has paid ₹ 20,000 as design and development charges for the said machine to a third party Softec Ltd. on behalf of ABC Ltd.

(iii) Moulds and dies worth ₹ 10,000 used in production of the machine, are supplied by XYZ Ltd. free of cost.

(iv) Bought out accessories of ₹ 8,000 are supplied with machine. The sale price of machinery (₹ 8,00,000) does not include the value of such bought out accessories.

Determine the excise duty payable on the machine for the purpose of central excise duty.

SSI exemption

4. ABC Manufacturing Co. is engaged in manufacturing three products A, B and C in three different factories. From the following particulars for the preceding financial year, find out whether ABC Manufacturing Co. is eligible for small scale exemption under *Notification No. 8/2003 CE dated 01.03.2003* for the current financial year:

S. No.	Particulars	Product 'A' ₹ (in lakh)	Product 'B' ₹ (in lakh)	Product 'C' ₹ (in lakh)
1.	Clearance of excisable goods exempted from payment of duty under a notification other than *Notification No. 8/2003 CE*	20	30	10
2.	Clearance of account books, falling under Heading 4820 of First Schedule to the Central Excise Tariff, bearing brand name of another person.	35	40	25

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3.	Clearance of excisable goods to United Nations exempted from payment of duty under *Notification No. 108/95-CE*	10	30	10
4.	Exports to UK	125	20	100
5.	Exports to Bhutan	20	20	10
6.	Clearance of goods (duty payable on the basis of annual capacity of production under section 3A of the Central Excise Act, 1944)	50	60	50
7.	Clearance of goods bearing the brand name of Khadi and Village Industries Commission (KVIC)	25	25	30

Circulars under central excise

5. "Circulars issued by the Central Board of Excise and Customs (CBEC), which are contrary to the judgements of the Supreme Court and the High Courts are not binding on the authorities under the respective statutes."

   Discuss the validity of the statement with the help of a decided case law and a recent circular issued by the CBEC in this regard.

Basic concepts of service tax

6. 10 persons, each contributing ₹ 1,000 per month, come together to organize a chit for 10 months, in June, 2015. Mr. A is the foreman of such chit fund. At the end of first month, ₹ 10,000 (₹ 1,000/- × 10) are available in the kitty of the chit fund. The said amount is put to auction by Mr. A and those subscribers who are interested in drawing the money early because of their needs participate in the auction. Mr. B, the successful bidder, offers the highest discount of ₹ 1,000 and thus, is given the chit amount.

   Mr. A receives ₹ 50 (5% of discount amount) as commission for conducting the proceedings of the chit. The balance ₹ 950 is distributed to all the subscribers as dividend.

   Examine whether the activity carried out by Mr. A is liable to service tax?

Penalty provisions

7. The Finance Act, 2015 has rationalised the penalty provisions under section 76 and section 78 of the Finance Act, 1994. Elucidate by comparing the penal provisions under these two sections.

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Basic concepts of service tax

8. Mr. A, a taxable service provider, provided taxable services to Mr. B. The contract of service entered into between them stipulated that Mr. A will bear all the taxes, duties and other liabilities in connection with discharge of his obligations. While the service was being provided, an amendment in the law shifted the liability to pay service tax in case of such taxable services from service provider to service receiver retrospectively, i.e. reverse charge provisions were made applicable.

   You are required to answer the following questions with the help of the decided case law(s), if any:

   (i) Can Mr. B, who is the person liable to pay service tax under reverse charge, shift the burden of such service tax on Mr. A by deducting the same from the payment made against the bills raised by Mr. A?

   (ii) Can Mr. B ask the Revenue to recover service tax from Mr. A since the contract of service stipulates that Mr. A will bear all the taxes, duties and other liabilities in connection with discharge of his obligations?

Declared service

9. Transfer of goods without transfer of right to use such goods is liable to service tax as declared service. With the help of decided Supreme Court rulings, explain the concept of "transfer of right to use goods" as also the guiding principles to determine whether a transaction involves "transfer of right to use goods". Give two examples of transfer of goods which do not involve transfer of right to use such goods.

Valuation of taxable services

10. Mr. P has received the following amounts from the activities undertaken by him during the quarter ended on 30th September, 2015:

S. No.	Particulars	₹ (in lakh)
(i)	Amount received for trading in Government securities*	7.00
(ii)	Amount received for trading in shares*	4.50
(iii)	Commission for acting as clearing and forwarding agent	18.25
(iv)	Commission earned on sale of goods belonging to others	1.75
(v)	Charges for providing auxiliary service relating to commodity futures	7.00
	Total	**38.50**

**represents difference between sale price and purchase price*

You are required to compute the value of taxable services and service tax liability of Mr. P for the said quarter.

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Note:

(i) Rate of service tax is 14% and all the above amounts are exclusive of service tax.

(ii) Mr. P is not eligible for small service provider's exemption under *Notification No. 33/2012 ST dated 20.06.2012*.

11. Hotel Beach Glory has provided the following information for the month of October, 2015:

S. No.	Services provided	(₹)
(i)	Serving of food in a restaurant with air-conditioned facility	3,00,000
(ii)	Supply of food in convention centre for organizing conferences alongwith renting thereof	2,80,000
(iii)	Renting of rooms (Declared Tariff: ₹ 2,500 per room per day)	1,20,000
(iv)	Catering services provided to a CBSE affiliated Higher Secondary School	60,000
(v)	Outdoor catering services provided to a Coaching Institute preparing students for engineering examinations	1,50,000
	Total	**9,10,000**

You are required to compute the value of taxable service and service tax liability of Hotel Beach Glory for the month of October, 2015.

Note:

(i) All the above amounts are exclusive of service tax.

(ii) Hotel Beach Glory is not eligible for small service provider's exemption under *Notification No. 33/2012 ST dated 20.06.2012* and does not avail CENVAT credit on inputs and capital goods.

12. Omega Pvt. Ltd. provides information technology software services. It has received the following amounts towards services provided by it during October, 2015:

S. No.	Particulars	(₹)
(i)	On-site development of software	80,000
(ii)	Sale of pre-packaged software put on CDs	2,50,000
(iii)	Advice, consultancy and assistance on matter relating to information technology software	20,000
(iv)	Customised development of software and delivery thereof to client on CD	1,00,000
(v)	Providing a licence to use pre-packaged software without transfer of right to use	60,000

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(vi)	Providing a license to use pre-packaged software with restrictions for end use	2,50,000

Compute the value of taxable services and service tax liability of Omega Pvt. Ltd. Wherever applicable, the above amounts are inclusive of service tax @ 14%. Omega Pvt. Ltd. is not eligible for small service provider's exemption under *Notification No. 33/2012 ST dated 20.06.2012.*

Appeals under service tax

13. Mr. T provides taxable services that are exported. He claimed rebate of service tax paid by him on input services used in providing the services being exported by him. However, the Assistant Commissioner of Central Excise denied such rebate claim. The order of the Assistant Commissioner of Central Excise was confirmed by the Commissioner (Appeals). Mr. T now wants to file an appeal with CESTAT against the said order of Commissioner (Appeals).

    With reference to the amendment made by the Finance Act, 2015, discuss whether Mr. T can file the appeal with CESTAT against the order of Commissioner (Appeals) denying service tax rebate.

Place of provision of service

14. ABC Fabricators has its factory located in Gujarat. It has temporarily imported certain goods from its customer located in China and re-exported them to China after carrying out the necessary repairs without putting them to any use in Gujarat.

    Examine what would be the place of provision of service in the given case with reference to the Place of Provision of Service Rules, 2012. Will your answer be different if the repaired goods are re-exported after being put to use in Gujarat for some time?

Adjustment of excess payment of service tax

15. Mr. X's service tax liability for the quarter ended on 30th September, 2015 was ₹ 10,000. However, while making the online payment of the same, Mr. X inadvertently paid ₹ 30,000. What recourse is available to him under rule 6(4A) of the Service Tax Rules, 1994?

    Will your answer be different if the excess payment is on account of non-availment of deduction towards property tax in case of renting of immovable property?

Valuation of imported goods and computation of customs duty

16. AST Ltd. has imported a machine from U.S. From the following information furnished by it, compute the assessable value and total customs duty payable under the Customs Act, 1962:

S. No.	Particulars	Amount
(i)	Cost of the machine at the factory of the exporter	US $ 20,000

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(ii)	Transport charges from the factory of exporter to the port for shipment	US $ 750
(iii)	Handling charges paid for loading the machine in the ship	US $ 100
(iv)	Freight charges from exporting country to India	US $ 5,000
(v)	Buying commission paid by the importer	US $ 100
(vi)	Lighterage charges paid by the importer at port of importation	₹ 15,000
(vii)	Freight incurred from port of entry to Inland Container depot	₹ 60,000
(viii)	Ship demurrage charges paid at port of importation	₹ 21,000

Other details are given hereunder:

Particulars	**Presentation of bill of entry**	**Entry inwards**
Date	20.01.2015	25.02.2015
Rate of basic customs duty	20%	10%
Rate of exchange notified by CBEC	₹ 60 per US $	₹ 65 per US $

Rate of additional duty payable under section 3(1) of the Customs Tariff Act, 1975	Rate of additional duty payable under section 3(5) of the Customs Tariff Act, 1975	Education cesses
12.5%	4%	As applicable

Advance ruling under custom laws

17. Mr. Q owns a sole proprietorship firm, 'Safe and Super Importers'. Mr. Q has never been to any place outside India. The firm proposes to import a product. Mr. Q is not sure of the correct classification of the product under Customs Tariff. His Tax Consultant has informed him that the said classification issue has been decided by the CESTAT in a different case. However, Mr. Q does not want to take any chances and is desirous of obtaining a ruling from the Authority for Advance Ruling under section 28H of the Customs Act, 1962 with respect to the classification of the product to be imported by it.

    In the light of recent amendments, state whether Safe and Super Importers can seek advance ruling in the present case under the Customs Act, 1962?

Duty drawback and levy of and exemptions from customs duty

18. (a) Xavier Exports have filed a duty drawback claim under All India Industry Rates (AIR). Owing to certain changes in their business model, they want to get the aforesaid claim revised by way of fixation of special brand rate of drawback.

    Briefly explain whether such a change is permissible under the Customs, Central Excise Duties and Service Tax Drawback Rules, 1995?

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(b) "Pilfered goods and destroyed goods are not dealt in the same manner under the Customs Act, 1962."

Elucidate and bring out the difference between the provisions pertaining to the two types of goods under Customs Act, 1962.

Illegal import, confiscation and penalty

19. Under Customs Act, 1962 can redemption fine be imposed and penalty under section 112 be levied after release of imported goods on execution of a bond, if it is found subsequently that there has been an irregularity in the import? Discuss with the help of decided case law(s), if any.

Foreign Trade Policy

20. (a) With reference to the provisions relating to Export Oriented Unit (EOU) Scheme as contained in Foreign Trade Policy, answer the following questions:

(i) An EOU has started production after 4 years 10 months from the date of grant of Letter of Permission (LoP). Is it correct?

(ii) A unit intending to trade in handicrafts wants to set up an EOU. Is it allowed?

(b) XYZ Co. Ltd., Delhi, with an active IEC, has provided research and development services on natural sciences* to a US based company in the current financial year. It has earned net foreign exchange to the tune of USD 14,000 in the preceding financial year. Can XYZ Co. Ltd. avail the benefit of Service Exports from India Scheme (SEIS) with respect to services provided by it?

**notified for availing benefit under Service Exports from India Scheme (SEIS)*

SUGGESTED ANSWERS / HINTS

1. No, I do not agree with the statement. Availability of an ointment without the prescription of a medical practitioner is not the relevant criterion to classify it as a cosmetic/toilet preparation; what is relevant is the function of the ointment i.e., whether the same is used for "care" or "cure".

The Supreme Court in the case of *CCEx. v. Ciens Laboratories 2013 (295) ELT 3 (SC)* laid down the following significant guiding principles to determine as to whether a product will be classified as a medicament or a cosmetic/toilet preparation:

(i) When a product contains pharmaceutical ingredients that have therapeutic or prophylactic or curative properties, the proportion of such ingredients is not invariably the decisive factor in classification. The relevant factor is the curative attributes of such ingredients that render the product a medicament and not a cosmetic.

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(ii) Though a product is sold without the prescription of a medical practitioner, it does not lead to the immediate conclusion that all products that are sold over / across the counter are cosmetics. There are several products that are sold over-the-counter and are yet, medicaments.

(iii) Prior to adjudicating upon whether a product is a medicament or not, it ought to be seen as to how do the people who actually use the product, understand it to be. If a product's primary function is "care" and not "cure", it is not a medicament. Medicinal products are used to treat or cure some medical condition whereas cosmetic products are used in enhancing or improving a person's appearance or beauty.

(iv) A product that is used mainly in curing or treating ailments or diseases and contains curative ingredients, even in small quantities, is to be treated as a medicament.

Based upon the above observations, the Supreme Court held that presence of pharmaceutical ingredients in the cream (in the instant case the impugned cream had pharmaceutical content) showed that it was used for prophylactic and therapeutic purposes namely, for curing dry skin conditions of the human skin and was not primarily intended to protect the skin; therefore, the same was classifiable as a medicament.

2. As per rule 2(d) of the CENVAT Credit Rules, 2004 (CCR), goods cleared by paying excise duty @ 2% under *Notification No. 1/2011 CE dated 01.03.2011* are exempted goods. Since, Gauri Manufacturers uses common input 'R' in the manufacture of both dutiable goods 'X' and exempted goods 'Y', rule 6 of CCR will apply in its case.

Where common inputs are used for manufacture of both dutiable and exempted final products and separate accounts for the same are not maintained, rule 6(3)(i) of the CCR provides an option to the manufacturer to avail full credit on common inputs by paying an amount of 6% of value of the exempted goods.

Computation of amount payable under rule 6(3)(i) and central excise duty payable

Particulars	(₹)
6% of value of the exempted goods (₹ 80 lakh × 6%)	4,80,000
Less: Duty of excise, paid @ 2% on the exempted goods [Note 1]	1,60,000
Amount payable under rule 6(3)(i) of CCR	**3,20,000**
Excise duty payable on goods 'X' [₹ 240 lakh × 12.5%]	30,00,000
CENVAT credit available [Note 2]	25,60,000
Excise duty payable in cash (₹ 3,20,000 +₹ 30,00,000 – ₹ 25,60,000) (A)	7,60,000
Excise duty payable on goods 'Y' in cash [₹ 80 lakh × 2%] [Note 3] (B)	1,60,000
Total central excise duty payable in cash (A) + (B)	**9,20,000**

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Notes:

1. Any excise duty paid on exempted goods has to be reduced from the amount payable under rule 6(3)(i) [First proviso to rule 6(3) of the CCR].
2. Since input 'P' is used only in manufacture of dutiable goods 'X', full credit thereof (₹ 16 lakh) will be available. Further, since option under rule 6(3)(i) is being exercised, full credit of common input 'R' (₹ 9.6 lakh) will also be available.
3. CENVAT credit cannot be utilized for discharging the excise duty liability on goods cleared under *Notification No. 1/2011 CE dated 01.03.2011* [Second proviso to rule 3(4) of CCR].

3. **Computation of assessable value of the machine**

Particulars	₹	₹
Sale price of the machine (excluding all taxes and duties)		8,00,000
Less: Trade discount [Note 1]	32,000	
Installation and erection expenses [Note 2]	30,000	62,000
		7,38,000
Add: Design and development charges [Note 3]		20,000
Moulds and dies supplied alongwith machine [Note 4]		10,000
Assessable value		7,68,000
Excise duty payable [₹ 7,68,000 × 12.5%]		**96,000**

Notes:

1. As the transaction value is the price actually paid or payable, trade discount is allowable as deduction.
2. Expenses on installation and erection incurred after the place of removal and resulting into an immovable property will not be included in the assessable value *[Circular No. 643/34/2002 CX dated 01.07.2002].*
3. Design and development charges of machine are included in the assessable value as such charges are 'in connection with sale'. Further, any amount paid on behalf of the manufacturer to a third party is also includible in the assessable value in terms of the definition of transaction value.
4. Value of moulds and dies used in the production of the goods supplied free of charge by buyer is includible in the assessable value [Explanation 1 to rule 6 of the Central Excise (Determination of Price of Excisable Goods) Rules, 2000].
5. Amount charged from the buyer in relation to any kind of packing is includible in the assessable value *[Circular No. 354/81/2000 CE dated 30.06.2000]*.

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6. Advertisement and publicity expenses borne by the buyer and warranty charges are included in the assessable value in terms of definition of the transaction value under section 4(3)(d) of Central Excise Act.

7. Since the pre-delivery inspection charges and after sales service charges have been charged by the manufacturer, they are included in the assessable value [Tata Motors Ltd. v. UOI 2012 (286) E.L.T. 161 (Bom.)].

8. Bought out accessories, supplied along with the machinery, will not be included in the assessable value *[Shriram Bearing Ltd. v. CCE 1997 (91) ELT 255 (SC)].*

4. In order to claim the benefit of exemption under *Notification No. 8/2003 CE dated 01.03.2003* in a financial year, the aggregate value of clearances of ALL excisable goods for home consumption by a manufacturer from one or more factories should not exceed ₹ 400 lakh in the preceding financial year. Therefore, in the given case, clearances of all the three products namely, Product A, Product B and Product C will be clubbed for computation of aggregate value of clearances for home consumption.

The aggregate value of clearances for home consumption of ABC Manufacturing Co. is ₹ 450 lakh in the preceding financial year [Refer computation given below]. Therefore, it is not eligible to claim the benefit of exemption under *Notification No. 8/2003 CE dated 01.03.2003* in the current financial year.

Computation of aggregate value of clearances for home consumption of ABC Manufacturing Co. for preceding financial year

Particulars	₹ (in lakh)
Clearances of excisable goods exempted from payment of duty under a notification other than *Notification No. 8/2003 CE* = ₹ 20 lakh + ₹ 30 lakh + ₹ 10 lakh	60
Clearances of account books bearing brand name of another person [Note 1] =₹ 35 lakh + ₹ 40 lakh + ₹ 25 lakh	100
Clearance of excisable goods to United Nations exempted from payment of duty under *Notification No. 108/95 CE* [Note 2]	Nil
Exports to UK [Note 3]	Nil
Exports to Bhutan [Note 3] = ₹ 20 lakh + ₹ 20 lakh + ₹ 10 lakh	50
Clearances of goods on which duty has been paid under section 3A of the Central Excise Act = ₹ 50 lakh + ₹ 60 lakh + ₹ 50 lakh	160

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Clearance of goods bearing the brand name of Khadi and Village Industries Commission (KVIC) [Note 1] = ₹ 25 lakh + ₹ 25 lakh + ₹ 30 lakh	80
Aggregate value of clearances in terms of *Notification No. 8/2003 CE*	450

Notes:

Notification No. 8/2003 CE dated 01.03.2003 provides that while determining the aggregate value of clearances for home consumption :-

1. clearances bearing the brand name of another person, which are ineligible for SSI exemption should be excluded. However, account books falling under heading 4820 of the First Schedule of the Central Excise Tariff and clearance of goods bearing the brand name of Khadi and Village Industries Commission (KVIC) are entitled to small scale exemption even if they bear a brand name or trade name whether registered or not, of another person. Therefore, such clearances will not be excluded.
2. clearances of excisable goods, without payment of duty, supplied to United Nations under *Notification No.108/95 CE* should be excluded.
3. export turnover should be excluded. However, exports to Bhutan are not excluded as these are treated as "clearance for home consumption".

5. **The statement is valid.**

The Supreme Court in the case of *Ratan Melting & Wire Industries v. CCE 2008 (231) ELT 22 (SC)* has held that circulars and instructions issued by the Board are undoubtedly binding in law on the authorities under the respective statutes, but when the Supreme Court or the High Court declares the law on the question arising for consideration, it would not be appropriate for the Court to direct that the circular should be given effect to and not the view expressed in a decision of this Court or the High Court. So far as the clarifications/circulars issued by the Central Government and of the State Government are concerned, they represent merely their understanding of the statutory provisions. They are not binding upon the Court. It is for the Court to declare what the particular provision of statute says and it is not for the Executive. A circular which is contrary to the statutory provisions has really no existence in law.

In the light of the aforesaid judgment, CBEC, vide *Circular No. 1006/13/2015 CX dated 21.09.2015*, has instructed its officers not to follow the Board Circulars contrary to the judgements of Hon'ble Supreme Court and High Court where Board has decided not to file an appeal on merit as such circulars become *non-est* in law.

6. Clause (44) of section 65B of Finance Act, 1994 defines service to mean *inter alia* any activity carried out by a person for another for consideration, and includes a declared service. The definition excludes *inter alia* an activity which constitutes merely a transaction in money or actionable claim.

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However, Explanation 2 to section 65B(44) of Finance Act, 1994 provides that the expression "transaction in money or actionable claim" does not include, *inter alia,* any activity carried out, for a consideration, in relation to, or for facilitation of, a transaction in money including the activity carried out by a foreman of chit fund for conducting or organising a chit in any manner.

Thus, the activity carried out by Mr. A is not a transaction in money but an activity carried out, for a consideration, in relation to, or for facilitation of, a transaction in money. Therefore, the activity carried out by Mr. A is a 'service' in terms of section 65B(44) and is liable to service tax.

7. Section 76 of the Finance Act, 1994 provides for the penalty for failure to pay service tax in non-fraud cases while section 78 provides for the penalty when service tax has not been paid on account of fraud etc. The Finance Act, 2015 has made substantial amendments in both the sections with a view to rationalize the penal provisions under these sections. The significant amendments made in these provisions are:

(i) Penalty under section 76 has been restricted to a maximum of 10% of service tax payable as against the earlier maximum of 50% of service tax payable.

(ii) Under the amended section 76, no penalty will be payable and proceedings in respect of service tax payable and interest thereon will be deemed to be concluded, if service tax and interest are paid within 30 days of the date of service of notice under section 73(1). The penalty payable will be reduced to 25% of the penalty imposed in the order, if service tax, interest and such reduced penalty are paid within 30 days of the receipt of the order. The erstwhile provisions of section 76 did not provide for such nil/reduced penalties.

(iii) Penalty leviable under section 78 for short/non-levy or short/non-payment or erroneous refund of service tax in fraud cases can be reduced to 15% of service tax payable and proceedings in respect of such service tax, interest and penalty will be deemed to be concluded, if service tax, interest and such reduced penalty are paid within 30 days of the date of service of notice under the proviso to section 73(1). Such provision of reduced penalty (15%) at the stage of service of notice was not provided in earlier section 78.

The provisions of section 76 and section 78 are compared in the table given below:

S. No.	Section 76	Section 78
1.	Penalty is leviable for short/non levy or short/ non payment or erroneous refund of service tax in non-fraud cases where notice has been served under section 73(1).	Penalty is leviable for short/non levy or short/non payment or erroneous refund of service tax on account of fraud etc. where notice has been served under proviso to section 73(1).

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2.	Penalty = up to 10% of such service tax	Penalty = 100% of service tax
3.	No penalty is payable if service tax and interest are paid within 30 days of the date of service of notice and proceedings in respect of such service tax, interest will be deemed to be concluded.	Penalty payable gets reduced to 15% of such service tax if service tax, interest and also such reduced penalty are paid within 30 days of the date of service of notice and proceedings in respect of such service tax, interest and penalty will be deemed to be concluded.
4.	Penalty payable gets reduced to 25% of the penalty imposed in the order, if service tax, interest and also such reduced penalty are paid within 30 days of the date of receipt of the order of the Central Excise Officer.	Penalty payable gets reduced to 25% of the service tax determined in the order, if service tax, interest and also such reduced penalty are paid within 30 days of the date of receipt of the order of the Central Excise Officer.
5.	Where penalty is increased in appellate proceedings, benefit of reduced penalty (25% penalty) will be available in respect of such increased amount of penalty and the period of 30 days will be counted from the date of such appellate order.	Where service tax or penalty is increased in appellate proceedings, benefit of reduced penalty (25% penalty) will be available in respect of such increased amount of service tax and the period of 30 days will be counted from the date of such appellate order.

8. **(i)** The issue as to whether an assessee (service receiver in this case) can shift the burden of service tax to the service provider by deducting the same from the payment made against the bills raised by the service provider, came up for consideration before the Supreme Court in the case of *Rashtriya Ispat Nigam Ltd. v. Dewan Chand Ram Saran 2012 (26) STR 289.*

On the issue of shifting of service tax liability, the Supreme Court held that service tax is an indirect tax which may be passed on. Thus, assessee can contract to shift its liability. The Finance Act, 1994 is relevant only between assessee and the tax authorities and is irrelevant in determining rights and liabilities between service provider and service recipient as agreed in a contract between them. There is nothing in law to prevent them from entering into agreement regarding burden of tax arising under the contract between them.

Therefore, owing to the contractual agreement which stipulates that Mr. A will bear all the taxes, Mr. B (the assessee under service tax) can shift the burden of service tax payable by him to Mr. A by deducting the same from the bills raised by Mr. A.

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(ii) The issue in this situation is that whether owing to a contractual agreement which stipulates that service tax will be borne by a person other than the assessee (service receiver in this case), will the obligation to discharge the service tax liability be also shifted to such other person.

Recently, the Delhi High Court dealt with a similar issue in the case of *Delhi Transport Corporation v. CST 2015 (038) STR 673 (Del).* In this case, the High Court held that though service tax burden can be transferred by contractual arrangement to the other party, statutorily the service provider is required to discharge the service tax liability and the assessee cannot ask the Revenue to recover the tax dues from a third party or wait for discharge of the liability by the assessee till it has recovered the amount from its contractors.

Since in the given case, the service receiver (Mr. B) is the assessee, the ruling will accordingly apply to him. Thus, Mr. B cannot ask the Revenue to recover service tax from Mr. A. Though Mr. B may contract to shift the tax liability to Mr. A, the responsibility to take registration, pay service tax and file service tax returns will be that of Mr. B and not Mr. A.

9. Transfer of goods by way of hiring, leasing, licensing or in any such manner without transfer of right to use such goods is a declared service [section 66E(f) of the Finance Act, 1994] liable to service tax. However, transfer of the right to use any goods for any purpose (whether or not for a specified period) for cash, deferred payment or other valuable consideration is a deemed sale liable to VAT/CST.

Transfer of right to use goods is a well recognized constitutional and legal concept. Every transfer of goods on lease, license or hiring basis does not result in transfer of right to use goods. **'Transfer of right of goods' involves transfer of possession and effective control over such goods** in terms of the judgment of the Supreme Court in the case of *State of Andhra Pradesh vs Rashtriya Ispat Nigam Ltd [Judgment dated 6/2/2002 in Civil Appeal No. 31 of 1991]*. Transfer of custody along with permission to use or enjoy such goods, *per se*, does not lead to transfer of possession and effective control.

The Apex Court in case of *BSNL v. UOI 2006 (2) STR 161 (SC)* has laid down the following test to determine whether a transaction involves transfer of right to use goods:-

- There must be goods available for delivery;
- There must be a consensus *ad idem* as to the identity of the goods;
- The transferee should have legal right to use the goods – consequently all legal consequences of such use including any permissions or licenses required therefor should be available to the transferee;
- For the period during which the transferee has such legal right, it has to be the exclusion to the transferor – this is the necessary concomitant of the plain language of the statute, viz., a 'transfer of the right to use' and not merely a license to use the goods;

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- Having transferred, the owner cannot again transfer the same right to others.

Whether a transaction amounts to transfer of right to use or not cannot be determined with reference to a particular word or clause in the agreement. The agreement has to be read as a whole, to determine the nature of the transaction.

Examples: (1) *Supply of equipment like excavators, wheel loaders, dump trucks, cranes, etc. for use in a particular project where the person to whom such equipment is supplied is subject to such terms and conditions in the contract relating to the manner of use of such equipment, return of such equipment after a specified time, maintenance and upkeep of such equipment:* This transaction does not involve transfer of right to use such equipment as in terms of the agreement the possession and effective control over such equipment has not been transferred even though the custody may have been transferred along with permission to use such equipment. The receiver is not free to use such equipment in any manner as he likes and conditions have been imposed on use and control of such equipment.

(2) *Hiring of bank lockers:* The transaction does not involve the right to use goods as possession of the lockers is not transferred to the hirer even though the contents of the locker would be in the possession of the hirer.

10. Computation of value of taxable service and service tax liability of Mr. P

Particulars	₹ (in lakh)
Amount received for trading in Government securities [Note 1]	Nil
Amount received for trading in shares [Note 1]	Nil
Commission for acting as clearing and forwarding agent [Note 2]	18.25
Commission earned on sale of goods belonging to others [Note 2]	1.75
Charges for providing auxiliary service relating to commodity futures [Note 2]	7.00
Value of taxable services	**27.00**
Service tax payable thereon @ 14%	**3.78**

Notes:

1. Trading of goods is covered in the negative list of services under section 66D(e) of the Finance Act, 1994 and is thus, not liable to service tax. Definition of goods under section 65B(25) includes 'securities' and definition of securities under section 65B(43) includes shares.
2. The services provided by clearing and forwarding agent or a commission agent are not in the nature of trading of goods. These are auxiliary for trading of goods. In terms of the provisions of section 66F(1) of the Finance Act, 1994, reference to a service does not include reference to a service used for providing such service.

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Further, the title in the goods never passes on to such agents to come within the ambit of trading of goods [Para 4.5.1 of CBEC's Education Guide on Taxation of Services].

Auxiliary services relating to commodity futures provided by agents are not covered in the negative list entry relating to trading of goods [Para 4.5.4 of CBEC's Education Guide on Taxation of Services].

11. **Computation of value of taxable services and service tax payable by Hotel Beach Glory**

Particulars	₹ (in lakh)	₹ (in lakh)
Serving of food in a restaurant with air-conditioned facility	3,00,000	
Value of service @ 40% [Note 1]		1,20,000
Supply of food in convention centre for organizing conferences alongwith renting thereof.	2,80,000	
Less: Abatement @ 30% [Note 2]	84,000	1,96,000
Renting of hotel rooms with declared tariff of ₹ 2,500 per room per day	1,20,000	
Less: Abatement @ 40% [Note 3]	48,000	72,000
Catering services provided to CBSE affiliated Higher Secondary School [Note 4]		Nil
Outdoor catering services provided to Coaching Institute preparing students for engineering examinations [Note 4]	1,50,000	
Value of service @ 60% [Note 5]		90,000
Value of taxable services		**4,78,000**
Service tax payable @ 14%		**66,920**

Notes:

1. Value of service portion in an activity wherein goods, being food or any other article of human consumption or any drink (whether or not intoxicating) is supplied in any manner as a part of the activity, at a restaurant, is 40% of the total amount charged for such supply, if the provider of taxable service has not taken CENVAT credit of duties paid on any goods classifiable under Chapters 1 to 22 of the Central Excise Tariff Act, 1985 [Rule 2C of Service Tax (Determination of Value) Rules, 2006].

2. Abatement of 30% is available in case of bundled service by way of supply of food or any other article of human consumption or any drink in a premises including *inter alia* convention center for organizing a function together with renting of such

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premises, if CENVAT credit on any goods classifiable under Chapters 1 to 22 of the Central Excise Tariff Act, 1985 used for providing the taxable service, has not been taken under the provisions of the CENVAT Credit Rules, 2004 *[Notification No. 26/2012 ST dated 20.06.2012].*

3. Services by a hotel, inn, guest house, club or campsite, by whatever name called, for residential or lodging purposes, having declared tariff of a unit of accommodation below ₹ 1,000 per day or equivalent are exempt from service tax vide *Notification No. 25/2012 ST dated 20.06.2012*. Since in this case, the declared tariff is ₹ 2,500, it will not be eligible for such exemption. However, an abatement of 40% is available vide *Notification No. 26/2012 ST dated 20.06.2012* in case of renting of hotels, if CENVAT credit on inputs and capital goods, used for providing the taxable service, has not been taken under the provisions of the CENVAT Credit Rules, 2004.

4. Services provided to an educational institution, by way of, *inter alia* catering are exempt from service tax. Educational institution means an institution providing services specified in section 66D(l) of the Finance Act, 1994 [*Notification No. 25/2012 ST dated 20.06.2012].* Services by way of education up to higher secondary school and education as a part of a curriculum for obtaining a qualification recognised by any law for the time being in force are *inter alia* covered in negative list of services under section 66D(l). Thus, while a CBSE affiliated Higher Secondary School will be an eligible educational institution for the purpose of exemption, a coaching institute preparing students for engineering examinations will not be eligible for exemption as it does not provide the qualification recognized by any law.

5. The value of service portion in outdoor catering wherein goods, being food or any other article of human consumption or any drink (whether or not intoxicating) is supplied in any manner as a part of such outdoor catering, is 60% of the total amount charged for such supply, if the provider of taxable service has not taken CENVAT credit of duties paid on any goods classifiable under Chapters 1 to 22 of the Central Excise Tariff Act, 1985 [Rule 2C of Service Tax (Determination of Value) Rules, 2006].

12. Computation of value of taxable services and service tax liability of Omega Pvt. Ltd.

Particulars	₹
On-site development of software [Note 1]	80,000
Sale of pre-packaged software put on CDs [Note 2]	Nil
Advice, consultancy and assistance on matter relating to information technology software [Note 3]	20,000

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Customised development of software and delivery thereof to client on CD [Note 4]	1,00,000
Providing a licence to use pre-packaged software without transfer of right to use [Note 5]	60,000
Providing a license to use pre-packaged software with restrictions for end use [Note 6]	2,50,000
Value of taxable service inclusive of service tax	5,10,000
Value of taxable service [excluding service tax](rounded off)	**4,47,368**
Service tax @ 14% $\left(5,10,000 \times \frac{14}{114}\right)$ **(rounded off)**	**62,632**

Notes :

1. Development of information technology software *inter alia* is a declared service under section 66E(d) of the Finance Act,1994 and is thus, liable to service tax.
2. Pre-packaged software which is put on a media is in the nature of goods *[Tata Consultancy Services v. State of Andhra Pradesh 2002 (178) ELT 22 (SC)]*. Sale of pre-packaged software put on CDs is, therefore, in the nature of sale of goods and is not liable to service tax.
3. Though advice, consultancy and assistance on matter relating to information technology software are not covered under section 66E(d), such activities when carried out by a person for another for consideration fall within the definition of service and hence, are chargeable to service tax.
4. In such a case although the software is finally delivered in the form of goods, since the contract is essentially for design and development of software, it would fall in the declared list under section 66E(d) and will thus, be liable to service tax.
5. Transfer of goods (here software) by way of licensing without transfer of right to use such goods is a declared service [section 66E(f) of the Finance Act, 1994] liable to service tax.
6. Providing a license to use pre-packaged software with restrictions for end use does not result in transfer of right to use the software within the meaning of Article 366(29A) of the Constitution. Thus, the same will again be liable to service tax as declared service under section 66E(f).

13. The Finance Act, 2015 has amended section 86 of the Finance Act, 1994 – which prescribes the provisions for filing an appeal before the CESTAT - to provide that a revision application will have to be filed against the order of Commissioner (Appeals) in matters involving service tax rebate, and not an appeal before CESTAT. The amendment is explained hereunder:

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(i) As per section 35EE of the Central Excise Act, 1944, in respect of orders passed by Commissioner (Appeals) relating to transit loss, processing loss, rebate of duty or export without payment of duty, a revision application has to be filed with the Revision Authority (Central Government). Section 83 of the Finance Act, 1994 makes applicable certain sections of the Central Excise Act so far as may be, in relation to service tax as they apply in relation to a duty of excise. Section 35EE of Central Excise Act, 1944 is one such section which had been made applicable to service tax vide the Finance Act, 2012.

(ii) As per section 86 of the Finance Act 1994, an appeal can be made to the CESTAT, *inter alia,* against an order passed by the Commissioner (Appeals). In line with the provisions of section 35EE, section 35B of Central Excise Act, 1944 bars an appeal to the CESTAT in respect of transit loss, processing loss, rebate of duty or export without payment of duty. However, there was no such restriction in section 86 under service tax.

(iii) With effect from 14.05.2015, the Finance Act, 2015 has amended section 86 to prescribe that remedy against the order passed by Commissioner (Appeals), in a matter involving rebate of service tax on input services or rebate of duty paid on inputs, used in providing the service which has been exported, shall lie in terms of section 35EE of the Central Excise Act.

Therefore, Mr. T cannot file the appeal with CESTAT against the order of Commissioner (Appeals) denying service tax rebate. Instead, he will have to file a revision application with the Revision Authority under section 35EE of the Central Excise Act, 1944.

14. In respect of goods that are required to be made physically available by the recipient of service to the provider of service in order to provide the service, place of provision of service is the location where the service is actually performed [Clause (a) of rule 4 of Place of Provision of Service Rules, 2012 (hereinafter referred as PoPS Rules)].

However, the said clause is not applicable in case of a service provided in respect of goods that are temporarily imported into India for repairs and are exported after the repairs without being put to any use in the taxable territory, other than that which is required for such repair. In such a case, place of provision of service would be determined by the general rule 3 of PoPS Rules, i.e. the location of service receiver.

In the given case, since goods have been temporarily imported by ABC Fabricators and have been re-exported after the repairs without being put to any use in Gujarat (taxable territory), place of provision of repair services carried out by ABC Fabricators will be determined by rule 3 of PoPS Rules. Consequently, the place of provision of service will be the location of service receiver, viz. China.

However, if repaired goods are re-exported after being put to use, the place of provision of service will be determined according to rule 4(a) of PoPs Rules, if the use to which such goods are put to is not required for such repair. Therefore in such a case, the place

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of provision of service will be the location where the service is actually performed, which in the given case is Gujarat. However, if the use is of such nature which is necessary for carrying out the repairs, the place of provision of service will again be determined as per rule 3 of PoPS Rules.

15. As per rule 6(4A) of Service Tax Rules, 1994, where an assessee has paid to the credit of Central Government any amount in excess of the amount required to be paid towards service tax liability for a month or quarter, as the case may be, the assessee may adjust such excess amount paid by him against his service tax liability for the succeeding month or quarter, as the case may be.

However, rule 6(4B) lays down that the self-adjustment of excess amount paid by him shall be subject to the condition that the excess amount paid is on account of reasons not involving interpretation of law, taxability, valuation or applicability of any exemption notification.

Since in the given case, the reason for excess payment of amount by Mr. X does not involve any interpretation of law, taxability, valuation or applicability of any exemption notification, he can adjust the excess payment of ₹ 20,000 against his service tax liability for the succeeding quarter.

In case of renting of immovable property, a deduction of property taxes paid in respect of the immovable property is allowed from the gross amount charged for renting of the said immovable property vide *Notification No. 29/2012 ST dated 20.06.2012*.

However, where any amount in excess of the amount required to be paid towards service tax liability has been paid on account of non-availment of such deduction, such excess amount may be adjusted against the service tax liability within 1 year from the date of payment of such property tax. The details of such adjustment shall be intimated to the Superintendent of Central Excise having jurisdiction over the service provider within a period of 15 days from the date of such adjustment.

Hence, Mr. X can adjust the excess amount paid on account of non-availment of deduction towards property tax against his service tax liability within 1 year from the date of payment of the property tax.

16. **Computation of assessable value and customs duty payable**

Particulars	US $
Cost of the machine at the factory of the exporter	20,000
Transport charges up to port	750
Handling charges at the port	100
FOB	20,850
	₹
FOB value in Indian rupees @ ₹ 60/- per $ [Note 1]	12,51,000.00

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Freight charges up to India [US $ 5,000 x ₹ 60]	3,00,000.00
Lighterage charges paid by the importer [Note 2]	15,000.00
Ship demurrage charges [Note 2]	21,000.00
Insurance charges @ 1.125% of FOB [Note 3]	14,073.75
CIF	16,01,073.75
Add: Landing charges @ 1% of CIF [Note 3]	16,010.74
Assessable value	16,17,084.49
Add: Basic customs duty @ 10% [Note 6] [a]	1,61,708.45
Total	17,78,792.94
Add: Additional duty u/s 3(1) of Customs Tariff Act, 1975 @ 12.5% of ₹ 17,78,792.94 [b]	2,22,349.12
Total	20,01,142.06
Add: Education cesses @ 3% of [(a) + (b)] [2% education cess + 1% secondary and higher education cess] [c]	11,521.73
Total [d]	20,12,663.79
Additional duty u/s 3(5) of Customs Tariff Act, 1975 @ 4% of (d) above [e] [Note 7]	80,506.55
Total custom duty payable [(a) +(b) + (c) + (e)]	4,76,085.85
Total custom duty payable (rounded off to nearest rupee)	**4,76,086.00**

Notes:

(1) Rate of exchange notified by CBEC on the date of presentation of bill of entry is considered for conversion of foreign currency into Indian currency. [Explanation to section 14 of the Customs Act, 1962].

(2) Cost of transport of the imported goods includes lighterage charges and ship demurrage charges [Explanation to Rule 10(2) of Customs Valuation (Determination of Value of Imported Goods) Rules, 2007].

(3) Insurance charges, if not ascertainable are to be included @ 1.125% of FOB value of goods. Landing charges have to be included @ 1% of CIF value of goods. [Clauses (iii) and (ii) of first proviso to rule 10(2) of Customs Valuation (Determination of Value of Imported Goods) Rules, 2007].

(4) Buying commission is not included in the assessable value [Rule 10(1)(a)(i) of Customs Valuation (Determination of Value of Imported Goods) Rules, 2007].

(5) Freight only up to the place of importation is includible in the assessable value. Therefore, freight incurred from port of entry to Inland Container depot is not includible in assessable value [Fourth proviso to rule 10(2) of Customs Valuation (Determination of Value of Imported Goods) Rules, 2007].

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(6) Rate of duty is the rate prevalent on the date of presentation of bill of entry or the rate prevalent on the date of entry inwards, whichever is later [Section 15 of the Customs Act, 1962].

(7) Education cess and secondary and higher education cess are not payable on special additional duty leviable under section 3(5) of Customs Tariff Act, 1975.

17. The advance ruling can only be obtained by an applicant as defined under section 28E(c) of the Customs Act, 1962. The "applicant" is defined under section 28E(c)(iii) to mean *inter alia* a resident falling within any such class or category of persons, as the Central Government may, by notification in the Official Gazette, specify in this behalf and who makes application for advance ruling under section 28H(1).

Earlier, public sector companies, resident public limited companies and resident private limited companies were notified as the class or category of resident persons who can apply for advance ruling relating to customs duty.

With effect from 01.03.2015, the scope of the class or category of resident persons who can apply for advance ruling relating to customs duty has been expanded vide *Notification No. 27/2015 Cus (NT) dated 01.03.2015* to cover a resident firm within this category. The definition of the expression "firm" for this purpose includes "sole proprietorship" and sole proprietorship means an individual who engages himself in an activity of import or export. The sole proprietorship will have to satisfy the test of residency as per section 2(42) of the Income Tax Act, 1961 to be eligible to apply for an advance ruling.

Therefore, Safe and Super Importers, being a resident proprietorship firm, is an eligible applicant for advance ruling under section 28E(c)(iii) of the Customs Act, 1962.

Further, advance ruling can be sought only for the matters specified under section 28H(2) of the Customs Act, 1962 and classification is one such matter prescribed thereunder. However, proviso to section 28-I(2) lays down that an advance ruling cannot be sought where the question raised is -

(a) already pending in the applicant's case before any officer of customs, the Appellate Tribunal or any Court;

(b) the same as in a matter already decided by the Appellate Tribunal or any Court.

Since in the given case, question intended to be raised by Safe and Super Importers is already decided by the CESTAT, advance ruling cannot be sought by it, despite it being an eligible applicant seeking an advance ruling on an eligible issue.

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18. **(a)** Under rule 7 of Customs, Central Excise Duties and Service Tax Drawback Rules, 1995, when the rate of duty drawback is lower than 4/5th of the duty/taxes paid, the manufacturer/exporter can apply for fixation of a special brand rate. However, the application for special brand rate cannot be made where a claim for drawback under rule 3 or rule 4 has already been made. In other words, where the exporter has already filed a duty drawback claim under All Industry Rates (AIR) Schedule, he cannot request for fixation of special brand rate of drawback.

Therefore in this case, since Xavier Exports have filed a duty drawback claim under All Industry Rates (AIR), it cannot request for fixation of a special brand rate.

(b) Pilfered goods and lost or destroyed goods are treated differently under the Customs Act, 1962. While the provisions relating to pilfered goods are dealt in section 13, provisions relating to lost or destroyed goods are covered under section 23(1).

Section 13 lays down that if any imported goods are pilfered after the unloading and before the proper officer has made an order for clearance for home consumption or deposit in a warehouse, the importer will not be liable to pay the duty leviable on such goods except where such goods are restored to the importer after pilferage.

Section 23(1) provides that without prejudice to the provisions of section 13, where it is shown to the satisfaction of the Assistant/Deputy Commissioner of Customs that any imported goods have been lost (otherwise than as a result of pilferage) or destroyed, at any time before clearance for home consumption, the Assistant/Deputy Commissioner of Customs will remit the duty on such goods.

The differences between the provisions pertaining to the two types of goods are tabulated below:

	Section 13	Section 23(1)
1.	No duty is payable on pilfered goods unless the same are restored to the importer.	Duty is payable on lost/destroyed goods but the same is remitted by Assistant Commissioner of Customs. Thus, unless remitted, duty has to be paid under section 23(1).
2.	Loss must be only due to pilferage.	Loss/destruction may be due to fire, flood etc. but not due to pilferage e.g. loss by leakage.
3.	Pilferage should be after unloading and before order for clearance for home consumption or warehousing.	Loss or destruction can be at any time before clearance for home consumption.
4.	Pilferage in warehouse is not	Loss/destruction in warehouse is

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	recognized under section 13.	recognized under section 23(1) as goods transferred to warehouse are not cleared for home consumption.
5.	Importer does not have to prove pilferage.	Burden of proof is on importer to prove loss or destruction.

19. The High Court in the case of *CCus. (Imports) v. Finesse Creation Inc. 2009 (248) ELT 122 (Bom.)* [maintained in *Commissioner v. Finesse Creation Inc. - 2010 (255) E.L.T. A120 (S.C.)*] has held that redemption fine can only be imposed when the goods are available and can be redeemed. The High Court has explained that if the goods are not available, they cannot be confiscated and consequently, cannot be redeemed. Once goods cannot be redeemed, redemption fine cannot be imposed.

However, when goods are provisionally released, confiscation would be possible since release is provisional and importer gets conditional possession and thus, redemption fine could also be imposed under section 125 of the Customs Act, 1962.

The Supreme Court in the case of *Weston Components Ltd. v. CC 2000 115 ELT 278* has held that the release of goods on execution of a bond would not take away the power of the Customs Authorities to levy redemption fine if subsequent to release of goods, import was found not valid or that there was any other irregularity which would entitle the customs authorities to confiscate the said goods.

Further, since penalty under section 112 can be imposed, *inter alia,* when a person does or omits to do any act which would render such goods *liable* for confiscation under section 111, such penalty can also be levied as the confiscation of goods is justifiable. It is important to note that for levying the penalty under section 112 it is immaterial as to whether goods are available for confiscation or not because the said penalty is imposed when the goods are liable for confiscation.

20. **(a)** **(i)** **No.** EOUs should start production within 2 years from the date of grant of Letter of Permission (LoP)/ Letter of Intent (LoI). In other words, LoP/ LoI have an initial validity period of 2 years, by which a unit should commence production. Its validity may be extended further up to 2 years by competent authority. However, proposals for extension beyond four years shall be considered in exceptional circumstances, on a case to case basis by Board of Approvals.

(ii) **No.** Units undertaking to export their entire production of goods and services (except permissible sales in DTA), may be set up under the EOU Scheme for manufacture of goods, including repair, re-making, reconditioning, re-engineering and rendering of services. Trading units are not covered under any of these schemes.

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(b) In order to be eligible for duty credit scrip entitlement under Service Exports from India Scheme (SEIS):-

(i) Service provider must be located in India.

(ii) It must provide only notified services in specified manner.

(iii) It must have an active IEC at the time of rendering such services for which rewards are claimed.

(iv) An individual service provider/Sole-proprietorship should have minimum net foreign exchange (NFE) earnings of USD 10,000 and a service provider other than individual/Sole-proprietorship should have minimum NFE of USD 15,000, in preceding financial year.

Although conditions (i) to (iii) are fulfilled in case of XYZ Co. Ltd., it is still not eligible for SEIS as it has failed to achieve the minimum net foreign exchange earnings of USD 15,000 in the preceding financial year.

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Applicability of Finance Act, Assessment Year etc.
for May, 2016 – Final Examination

Paper 7 : Direct Tax Laws & Paper 8 : Indirect Tax Laws

Applicability of Finance Act, Assessment Year etc. for May, 2016 Examination

The provisions of direct tax laws (income-tax) and indirect tax laws, as amended by the Finance Act, 2015, including notifications and circulars issued up to 31st October, 2015, are applicable for May, 2016 examination. The relevant assessment year for Paper 7: Direct Tax Laws is A.Y.2016-17.

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ANNEXURE

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Part I : Statutory Update – Indirect Tax Laws

Significant Notifications and Circulars issued between 1st May, 2015 and 31st October, 2015

SECTION A: CENTRAL EXCISE

Chapter 2: Classification of Excisable Goods

1. Withdrawal of circular classifying coconut oil packed in small size containers upto 200 ml as Hair oil

Earlier, *Circular No. 890/10/2009 dated 3.6.*2009 had clarified that coconut oil packed in small container of sizes upto 200 ml was classifiable under Central Excise Tariff Heading 3305 as Hair oil.

However, in the case of *Raj Oil Mills Ltd. v. CCE 2014 (314) ELT 541 (Tri.-Mumbai)* [maintained by SC], it has been held that edible coconut oil in retail packing of 200 ml or less is classifiable under Chapter 15 covering animal or vegetable fats and oils and not under Chapter 33 covering Cosmetics and Toilet Preparation.

Further, in the case of *Capital Technologies Ltd. & Ors v. CCE 2015 (321) ELT 479 (Tri.-Bang.)* [maintained by SC] also, it was held that the edible coconut oil packed in retail packs of 50 ml, 100 ml, 200 ml and 500 ml would be classifiable as coconut oil under heading 1513 and not as Hair oil under heading 3305.

Thus, in view of the said judicial pronouncements, aforesaid circular has been withdrawn vide *Circular No.1007/14/2015 CE dated 12.10.2015*. The issue of classification would be decided considering the facts of the case read with the judicial pronouncements.

Chapter 4: CENVAT Credit

1. No refund of CENVAT credit under rule 5B to service providers providing manpower supply/ security services

Rule 5B of the CENVAT Credit Rules, 2004 provides that service providers, rendering notified reverse charge services, being unable to utilise the CENVAT credit availed on inputs and input services for payment of service tax on such output services, shall be allowed refund of such unutilised CENVAT credit.

In this regard, earlier following partial reverse charge services were notified:

(i) renting of a motor vehicle designed to carry passengers on non-abated value, to any person who is not engaged in a similar business;

(ii) supply of manpower for any purpose or security services; or

(iii) service portion in the execution of a works contract

Since with effect from 01.04.2015, service tax with respect to supply of manpower for any purpose or security services is payable on the basis full reverse charge, service providers of said services will no longer be eligible for refund of CENVAT credit availed

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on inputs and input services for payment of service tax on such output services. Further, application in Form A for claiming refund has also been suitably modified.

The aforesaid amendment is effective from April 01, 2015.

[Notification No. 15/2015 CE (NT) dated 19.05.2015]

2. **Reversal of credit under rule 6 not required in case of ethanol produced from molasses generated from cane crushed in the sugar season 2015-16 [Clause (ix) inserted to rule 6(6) of the CENVAT Credit Rules, 2004]**

   The provisions of sub-rules (1), (2), (3) and (4) of rule 6 would not apply to ethanol produced from molasses generated from cane crushed in the sugar season 2015-16 i.e. 1st October, 2015 onwards, for supply to the public sector oil marketing companies, namely, Indian Oil Corporation Ltd., Hindustan Petroleum Corporation Ltd. or Bharat Petroleum Corporation Ltd., for the purposes of blending with petrol, under *Notification No.12/2012 CE dated 17.03.2012*.

   In case of such removal, though ethanol is removed without payment of duty, CENVAT credit on inputs/capital goods/input services used in the manufacture of ethanol can be availed. Further, where common inputs/input services are used to manufacture ethanol and other dutiable final product, reversal of credit or payment of amount on removal of ethanol will not be required.

   [Notification No. 21/2015 CE (NT) dated 07.10.2015]

3. **Output service providers allowed to utilize credit of education cess (EC) and secondary and higher education cess (SHEC) for payment of service tax on any output service [Sixth, seventh and eighth provisos inserted to rule 3(7)(b) of the CENVAT Credit Rules, 2004]**

   Prior to 01.03.2015, education cess (EC) and secondary and higher education cess (SHEC) paid on excisable goods could be availed as CENVAT credit. Further, EC and SHEC paid on taxable services could also be availed as CENVAT credit till 31.05.2015. Credit of EC on excisable goods or taxable services could not be utilised for payment of any other duty except EC payable on excisable goods or taxable services. Similarly, credit of SHEC on excisable goods or taxable services could not be utilised for payment of any other duty except SHEC payable on excisable goods or taxable services.

   However, pursuant to EC and SHEC leviable on all taxable services ceasing to have effect (with effect from 01.06.2015), an output service provider has been allowed to utilise the following credits of EC and SHEC for the payment of service tax on any output service:

   (i) credit of EC and SHEC paid on inputs/ capital goods received in the premises of the output service provider on or after 01.06.2015;

   (ii) credit of balance 50% EC and SHEC paid on capital goods received in the premises of the output service provider in the financial year 2014-15; and

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(iii) credit of EC and SHEC paid on input service in respect of which the invoice, bill, challan or Service Tax Certificate for Transportation of Goods by Rail (referred to in rule 9), as the case may be, is received by the output service provider on/ after 01.06.2015.

[Notification No. 22/2015 CE (NT) dated 29.10.2015]

4. Amount payable under rule 6(3)(i) of CENVAT Credit Rules, 2004 enhanced from 6% to 7% of the value of exempted services

Earlier, in case an output service provider provides output service chargeable to tax as well as exempted services, he had an option to avail CENVAT credit in respect of any inputs/ input services without maintaining separate accounts provided he has paid an amount equal to 6% of the value of exempted services [Rule 6(3)(i) of the CENVAT Credit Rules, 2004].

With effect from 01.06.2015, pursuant to increase in the rate of service tax from 12% to 14%, aforesaid rate has been enhanced from 6% to 7%. Further, if any part of the value of a taxable service has been exempted on the condition that no CENVAT credit of inputs and input services, used for providing such taxable service, shall be taken, amount specified in rule 6(3)(i) has also been enhanced to 7% of the value so exempted.

[Notification No. 14/2015 CE (NT) dated 19.05.2015]

5. Clarification regarding CENVAT credit in transit sale through dealer

If goods are directly sent to any person on the direction of the registered dealer, the invoice will also contain the details of the registered dealer as the buyer and the person as the consignee, and that person will take CENVAT credit on the basis of the registered dealer's invoice [Third proviso to rule 11(2)]. Further, if the goods imported under the cover of a bill of entry are sent directly to buyer's premises, the invoice issued by the importer should mention that goods are sent directly from the place or port of import to the buyer's premises [Fourth proviso to rule 11(2)].

In this regard, following clarifications have been issued:

(i) Where a registered dealer negotiates sale of an entire consignment from a manufacturer/a registered importer and orders direct transport of goods to the consignee, credit can be availed by the consignee on the basis of invoice issued by the manufacturer or the registered importer. In such cases no CENVATABLE invoice shall be issued by the registered dealer in favour of the consignee though commercial invoice can be issued. Where a registered dealer negotiates sale of goods from the total stock ordered on a manufacturer or an importer to multiple buyers and orders direct transportation of goods to the consignees and the manufacturer or the importer is willing to issue individual invoices for each sale in favour of the consignees for such individual sale, the same procedure shall apply.

(ii) Where a registered dealer negotiates sale by splitting a consignment procured from a manufacturer or a registered importer and issues CENVATABLE invoices for each of the sale, it would now be possible for the dealer to order direct transport of the consignments as per the individual sales to the consignee without bringing the

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goods to his godown. This would save time and transportation cost for the dealer adding to ease of doing business. This is a new facility which flows from the amended provisions. Procedure as prescribed in the third proviso of rule 11(2) shall be applicable in such case.

(iii) Where a un-registered dealer negotiates sale of an entire consignment from a manufacturer or a registered importer and orders direct transport of goods to the consignee, credit can be availed by the consignee on the basis of invoice issued by the manufacturer or the registered importer. As the dealer is not registered, there is no question of issuing any CENVATABLE invoice by him . Such dealers as in the past can continue to be un-registered.

(iv) Where goods are sold by the registered importer to an end-user (say a manufacturer) who would avail credit on the basis of importer's invoice and the goods are transported directly from the port or warehouse at the port to the buyer's premises, the amendment prescribes that for such movement the factum of such direct transport to the buyer's premises needs to be recorded in the invoice.

[Circular No. 1003/10/2015 CX dated 05.05.2015]

<u>Chapter-5: General Procedures Under Central Excise</u>

1. Centralised registration allowed to manufacturers of aluminium roofing panels subject to fulfillment of specified conditions

Every manufacturing unit engaged in the manufacture of aluminium roofing panels* has been exempted from obtaining the central excise registration, subject to fulfillment of the following conditions:

(i) such roofing panels are consumed at the site of manufacture for execution of the project and

(ii) manufacturer of such goods has a centralised billing or accounting system in respect of such goods manufactured by different manufacturing units and he opts for registering only the premises or office from where such centralised billing or accounting is done.

**falling under tariff item 7610 90 10 of the First Schedule to the Central Excise Tariff Act, 1985*

[Notification No. 17/2015 CE (NT) dated 08.06.2015]

2. Conditions, safeguards and procedure for preserving digitally signed records and issuing digitally signed invoices prescribed

Rule 10(4) and rule 11(8) of the Central Excise Rules, 2002 provide for authentication of every page of excise records preserved in electronic form and of invoices respectively, by means of digital signatures. Further, rule 10(5) and rule 11(9) have authorized CBEC to notify the conditions, safeguards and procedure to be followed by an assessee for preserving digitally signed records and issuing digitally signed invoices.

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In this regard, following conditions, safeguards and procedure have been prescribed vide *Notification No. 18/2015 CE (NT) dated 06.07.2015*:

(a) Every assessee proposing to use digital signature shall use Class 2* or Class 3** Digital Signature Certificate duly issued by the Certifying Authority in India.

> ***Class 2 Certificate:** These certificates are issued for both business personnel and private individuals use and are available for download after verifying a person's identity against a trusted and pre-verified database.
>
> ****Class 3 Certificate:** This certificate is issued to individuals as well as organizations. Since these are high assurance certificates, primarily intended for e-commerce applications, they shall be issued to individuals only on their personal (physical) appearance before the Certifying Authorities.

(b) Every assessee proposing to use digital signatures shall intimate the following details to the jurisdictional Deputy/ Assistant Commissioner of Central Excise, at least 15 days in advance:

- name, e-mail id, office address and designation of the person authorised to use the digital signature certificate;
- name of the Certifying Authority;
- date of issue of digital certificate and validity of the digital signature with a copy of the certificate issued by the Certifying Authority along with the complete address of the said Authority.

However, in case of any change in aforesaid details, complete details shall be submitted afresh within 15 days of such change.

In case of assessees already using digital signature, aforesaid details should be intimated within 15 days of issue of this notification.

(c) Every assessee who opts to maintain records in electronic form:

(i) and has more than one factory/ service tax registration shall maintain separate electronic records for each factory/ service tax registration.

(ii) shall on request (in a letter or e-mail) by a Central Excise Officer, produce the specified records in electronic form and invoices through e-mail or on a specified storage device in an electronically readable format for verification of the authenticity of the document.

(iii) shall ensure that appropriate backup of records in electronic form is maintained and preserved for a period of 5 years immediately after the financial year to which such records pertain.

(d) A Central Excise Officer, during an enquiry, investigation or audit, may direct an assessee to furnish printouts of the records in electronic form and invoices and may resume printouts of such records and invoices after verifying the correctness of the same in electronic format; and after the print outs of such records in electronic form

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have been signed by the assessee or any other person authorised by the assessee in this regard, if so requested by such Central Excise Officer.

Note: The above conditions will also apply in case of preservation of service tax records in electronic form and authentication of service tax invoices by digital signatures.

Further, all importers and exporters using services of Customs Brokers for formalities under Customs Act, 1962, shipping lines and air lines have also been required to file customs documents under digital signature certificates mandatorily with effect from 01.01.2016. The importers/ exporters desirous of filing Bill of Entry or Shipping Bill individually may however have the option of filing declarations/ documents without using digital signature [Circular No. 26/2015 Cus. dated 23.10.2015].

Chapter 6: Export Procedures

1. **Exemption from sealing in a package/container to export of bulk cargo [for e.g. coal, iron-ore, alumina concentrate, heavy machinery etc.] which is difficult to seal in packages/container**

The conditions and procedure relating to export (under bond) without payment of duty to all countries except Bhutan are contained in *Notification No. 42/2001 CE (NT) dated 26.06.2001* issued under rule 19 of the Central Excise Rules, 2002. The said notification stipulates that before clearing the export consignments from the factory/ warehouse/ any other approved premises, goods needs to be sealed-either by Central Excise Officer after examination of such goods or by the exporter himself under self-sealing and self certification.

However, bulk cargo e.g. coal, iron-ore, alumina concentrate, heavy machinery etc. are difficult to seal in packages or container. Consequently, *Notification No. 23 /2015 CE (NT) dated 30.10.2015* has been issued which provides that where the nature of goods is such that the goods cannot be sealed in a package or a container such as coal or ore, etc., exemption from sealing of package or container may be granted by the Principal Chief Commissioner/ Chief Commissioner of Central Excise subject to safeguard as may be specified by him in the permission.

The safeguards shall, *inter-alia*, include the following:-

(i) method of verification of quantity and quality of goods including testing of goods where necessary at the place of removal or despatch and at the port of export or SEZ, where the goods are received;

(ii) no remission of duty shall be allowed for loss of goods within transit;

(iii) permission shall be given on case to case basis for a specified period not exceeding 1 year at a time and may be withdrawn in case of misuse; and

(iv) any additional safeguards as may be specified.

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Chapter 14: Notifications, Departmental Clarifications and Trade Notices

1. **Board Circulars contrary to Supreme Court and High Court judgments (where Board has decided not to file an appeal on merit) not binding on Departmental officers**

Supreme Court in case of *Ratan Melting & Wire Industries v. CCE 2008 (231) E.L.T. 22 (S.C.)* has held that circulars and instructions issued by the Board are no doubt binding in law on the authorities under the respective statutes, but when the Supreme Court or the High Court declares the law on the question arising for consideration, it would not be appropriate for the Court to direct that the circular should be given effect to and not the view expressed in a decision of this Court or the High Court. So far as the clarifications/ circulars issued by the Central Government and of the State Government are concerned they represent merely their understanding of the statutory provisions. They are not binding upon the Court. It is for the Court to declare what the particular provision of statute says and it is not for the Executive. A circular which is contrary to the statutory provisions has really no existence in law.

In the light of the aforesaid judgment, CBEC, vide *Circular No. 1006/13/2015-CX dated 21.09.2015*, has clarified that Board Circulars contrary to the judgements of Hon'ble Supreme Court and High Court judgments where Board has decided not to file an appeal on merit, become non-est in law and should not be followed.

All pending cases decided after the date of the judgement would, conform to the law laid by the Hon'ble Supreme Court or High Court, as the case may be, irrespective of whether the circular has been rescinded or not.

SECTION B: SERVICE TAX

Chapter 5: Exemptions and Abatements

1. **Services provided under the Power System Development Fund Scheme of the Ministry of Power exempted from service tax**

Exemption from service tax has been granted to taxable services provided under the Power System Development Fund Scheme of the Ministry of Power by way of-

(A) re-gasification of Liquefied Natural Gas (LNG) imported by the Gas Authority of India Limited (GAIL);

(B) transportation of the incremental Re-gasified Liquefied Natural Gas (RLNG) (e-bid RLNG) to specified power generating companies or plants

subject to fulfillment of certain conditions prescribed in the exemption notification.

However, the exemption shall not be available if such RLNG and LNG are used for generation of electrical energy by captive generating plant as defined in section 2(8) of the Electricity Act, 2003.

Further, the exemption shall be valid only till 31.03.2017.

[Notification No. 17/2015 ST dated 19.05.2015]

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2. **Yoga included in the definition of charitable activities**

Mega Exemption *Notification No. 25/2012 ST dated 20.06.2012* exempts services by an entity registered under section 12AA of the Income-tax Act, 1961 by way of charitable activities.

Activities relating to advancement of religion or spirituality are included in the definition of charitable activities. Now yoga has also been included therein. Thus, services relating to advancement of yoga provided by charitable entities registered under section 12AA of the Income-tax Act, 1961 will not be liable to service tax e.g., service tax will not be payable on fee charged for yoga camps conducted by charitable trusts.

[Notification No. 20/2015 ST dated 21.10.2015]

3. **Services provided by (i) business facilitator/business correspondent with respect to Basic Savings Bank Deposit Accounts covered by Pradhan Mantri Jan Dhan Yojana and (ii) an intermediary to business facilitator/business correspondent with respect to such services, exempt from service tax**

With a view to promote financial inclusion, Mega Exemption *Notification No. 25/2012 ST dated 20.06.2012* has been amended to exempt the services provided by a business facilitator or a business correspondent to a banking company with respect to Basic Savings Bank Deposit Accounts covered by Pradhan Mantri Jan Dhan Yojana (PMJDY) by way of account opening, cash deposits, cash withdrawals, obtaining e-life certificates and Aadhar seeding, in the rural area branches of banking companies, from service tax. Further, the services provided by any person as an intermediary to a business facilitator or a business correspondent with respect to the above mentioned services, have also been exempted from service tax.

For this purpose, Basic Savings Bank Deposit Account has been defined to mean a Basic Savings Bank Deposit Account opened under the guidelines issued by Reserve Bank of India relating thereto.

[Notification No. 20/2015 ST dated 21.10.2015]

4. **70% abatement available on ancillary services provided by a GTA in the course of transportation of goods**

It has been clarified that ancillary services such as loading/ unloading, packing/unpacking, transshipment, temporary storage etc., would form part of the goods transport agency's (GTA) service if such services are provided by a GTA in the course of transportation of goods and the charges for such services are included in the invoice issued by the GTA, and not by any other person. Thus, abatement of 70%, applicable to GTA service, would also be available to the ancillary services. In other words, a single composite service need not be broken into its components and need not be considered as constituting separate services, if it is provided as such in the ordinary course of business. Thus, a composite service should be treated as a single service based on the main or principal service.

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It has also been clarified that in cases where GTA undertakes to deliver goods at a destination within a stipulated time, it should be considered as services of GTA in relation to transportation of goods. Thus abatement of 70% will be applicable if the entire transportation of goods is by road and the GTA issues a consignment note, by whatever name called.

[Circular No. 186/5/2015 dated 05.10.2015]

5. **Section 11C benefits granted to MTSO agents in relation to remittance of forex from outside India for disputed period (01.07.2012 to 13.10.2014)**

During the period between 01.07.2012 and 13.10.2014, service tax was not being levied and paid on the services provided by an Indian Bank or other entity acting as an agent to the Money Transfer Service Operators (MTSO) in relation to remittance of foreign currency from outside India to India, in terms of a practice that was generally prevalent at that time. However, this service was liable to service tax as also clarified vide *Circular No. 180/06/2014 ST dated 14.10.2014.*

Now, the Central Government, in exercise of the powers conferred by section 11C of the Central Excise Act, 1944 [as made applicable to like matters in service tax vide section 83 of the Finance Act, 1994] has directed that the service tax payable on the service provided by an Indian Bank or other entity acting as an agent to the MTSO in relation to remittance of foreign currency from outside India to India, in the said period, but for the said practice, shall not be required to be paid.

[Notification No. 19/2015 ST dated 14.10.2015]

Note: *Circular No. 180/06/2014 ST dated 14.10.2014 clarified that the services provided by an Indian Bank or other entity acting as an agent to MTSO in relation to remittance of foreign currency from outside India to India are liable to service tax.*

Chapter 7: Demand, Adjudication and Offences

1. **Monetary threshold limits enhanced for prosecution and arrest in central excise and service tax**

Prosecution

Revised guidelines have been issued on prosecution under central excise and service Tax. The significant aspects of the guidelines are:

(a) Monetary limit: Prosecution will normally not be launched unless evasion of central excise duty or service tax, or misuse of CENVAT credit in relation to offences specified under section 9(1) of the Central Excise Act, 1944 or section 89(1) of the Finance Act, 1994 is equal to or more than **₹ 1 crore**. It may be noted that though there is no change in the monetary limits (₹ 50 lakh) prescribed under the concerned sections, these directions have been issued to optimally utilize limited resources of the Department.

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(b) Habitual evaders: Notwithstanding the above limits, prosecution can be launched in the case of a company/ assessee habitually evading tax/ duty or misusing CENVAT credit facility.

A company/ assessee would be treated as habitually evading tax/ duty or misusing CENVAT credit facility, if it has been involved in 3 or more cases of confirmed demand (at the first appellate level or above) of central excise duty or service tax or misuse of CENVAT credit involving fraud, suppression of facts etc. in past 5 years from the date of the decision such that the total duty or tax evaded or total credit misused is equal to or more than **₹ 1 crore**.

(c) Authority to sanction prosecution: The criminal complaint for prosecuting a person can be filed only after obtaining the sanction of the Principal Chief/Chief Commissioner of Central Excise or Service Tax as the case may be. Once the sanction for prosecution has been obtained, criminal complaint in the court of law will be filed as early as possible by an officer of the jurisdictional Commissionerate authorized by the Commissioner.

(d) Cases when prosecution would not be filed: Prosecution would not be filed merely because a demand has been confirmed in the adjudication proceedings particularly **in cases of technical nature or where interpretation of law is involved.**

(e) Adequacy of evidence: One of the important considerations for deciding whether prosecution can be launched is the availability of adequate evidence. The standard of proof required in a criminal prosecution is higher as the case has to be established beyond reasonable doubt whereas the adjudication proceedings are decided on the basis of preponderance of probability. Therefore, even cases where demand is confirmed in adjudication proceedings, evidence collected would be weighed so as to likely meet the test of being beyond reasonable doubt for recommending prosecution. Decision will be taken on case-to-case basis considering various factors, such as, nature and gravity of offence, quantum of duty/tax evaded or CENVAT credit wrongly availed and the nature as well as quality of evidence collected.

(f) Stage for launching of prosecution: Normally, prosecution may be launched immediately on completion of adjudication proceedings.

If the party deliberately delays completion of adjudication proceedings, prosecution may be launched even during the pendency of the adjudication proceedings, where offence is grave and qualitative evidences are available [in view of the decision of Supreme Court in case of *Radhe Shyam Kejriwal 2011(266)ELT 294* [discussed in detail under Customs section].

[Circular No.1009/16/2015 CX dated 23.10.2015]

Arrest

Pursuant to the enhancement in prosecution limits, monetary limits for arrest have also been enhanced. Henceforth, arrest of a person in relation to offences specified under clauses (a) to (d) of section 9(1) of the Central Excise Act, 1944 or under clauses (i) or (ii)

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of section 89(1) of the Finance Act, 1994, may be made in cases where the evasion of central excise duty/ service tax or the misuse of CENVAT credit is equal to or more than **₹ 1 crore.**

[Circular No.1010/16/2015 CX dated 23.10.2015]

SECTION C: CUSTOMS AND FOREIGN TRADE POLICY

Chapter 11: Duty Drawback

1. **Safeguard duties are rebatable as duty drawback**

With respect to safeguard duties which are leviable under section 8B or section 8C of the Customs Tariff Act, 1975 read with section 12 of the Customs Act, it is clarified that these are rebatable as drawback in terms of section 75 of the Customs Act.

Since safeguard duties are not taken into consideration while fixing All Industry Rates of drawback, the drawback of the same can be claimed under an application for Brand Rate under rule 6 or rule 7 of the Customs, Central Excise Duties and Service Tax Drawback Rules, 1995. This implies that drawback shall be admissible only where the inputs which suffered safeguard duties were actually used in the goods exported as confirmed by the verification conducted for fixation of Brand Rate.

Further, where imported goods subject to safeguard duties are exported out of the country as such, then the drawback payable under section 74 of the Customs Act would also include the incidence of safeguard duties as part of total duties paid, subject to fulfillment of other conditions.

[Circular No. 23/2015 Cus dated 29.09.2015]

Chapter 12: Provisions relating to Illegal Import, Illegal Export, Confiscation, Penalty and Allied Provisions

1. **Monetary threshold limits enhanced for prosecution and arrest under customs**

Prosecution

Revised guidelines have been issued on prosecution under Customs Act, 1962. The significant aspects of the guidelines are:

(a) Person liable to be prosecuted: As per the provisions of the Customs Act, prosecution may be launched against any person including legal person for offences covered under sections 132, 133, 134, 135, 135A or 136 of the Customs Act, 1962.

(b) Threshold limits for launching of prosecution: CBEC has laid down the following threshold limits for launching prosecution:

S. No.	Particulars	Threshold limits
(i)	Baggage and Outright smuggling cases:	
	(a) Cases involving unauthorized importation in baggage/ cases under Transfer of Residence Rules	CIF value of the goods involved is ₹ 20 lakh or more

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	(b) Outright smuggling of high value goods such as precious metal, restricted items or prohibited items notified under section 11 of the Customs Act, 1962 or goods notified under section 123 of the Act or offence involving foreign currency	Value of offending goods is ₹ 20 lakh or more
(ii)	**Appraising Cases/ Commercial Frauds**	
	(a) Importation of trade goods involving wilful mis-declaration in value/ description of goods/ concealment of restricted goods/ goods notified under section 11 of the Act	CIF value of the offending goods is ₹ 1 crore or more
	(b) Fraudulent availment of drawback or attempt to avail of drawback or any exemption from duty provided under the Customs Act, 1962	Amount of drawback or exemption from duty is ₹ 1 crore or more
	(c) Exportation of trade goods involving wilful mis-declaration in value /description, concealment of restricted goods or goods notified under section 11 of the Customs Act, 1962	FOB value of the offending goods is ₹ 1 crore or more

(c) Exceptions:

Threshold limit will not apply in following cases:

(i) In case of habitual offenders or where criminal intent is evident in ingenious way of concealment, where prosecutions can be considered irrespective of the value of goods/currency involved in such professional or habitual offenders, etc. provided the cumulative value of 3 or more such offences in past 5 years from the date of the decision exceeds the threshold limit(s) indicated in above table.

(ii) In cases involving offences relating to items i.e., fake Indian currency notes (FICN), arms, ammunitions and explosives, antiques, art treasures, wild life items and endangered species of flora and fauna, prosecution would be launched invariably, irrespective of value of offending goods involved.

(iii) In respect of cases involving non-declaration of foreign currency by foreign nationals and NRIs detected at the time of departure back from India, exceeding the threshold limits of ₹ 20 lakh, if it is claimed that the currency has been legally acquired and brought into India, prosecution would not be considered as a routine.

Prosecutions will not be launched as a matter of routine and/or in cases of technical nature, where the additional claim for duty is based solely on a difference of interpretation of the law.

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(d) Authority to sanction prosecution: Prosecution may be launched after due sanction by the Commissioner / Principle Commissioner or Additional Director General / Principle Additional Director General of Revenue Intelligence (collectively known as 'sanctioning authority'). However, in case of habitual offenders and appraising cases/commercial frauds, prior approval of the Chief Commissioner/Principal Chief Commissioner or Director General/Principal Director General of Revenue Intelligence, as the case may be, will be required for launching prosecution.

(e) Stage for launching of prosecution: Normally, prosecution may be launched immediately on completion of adjudication proceedings.

Exceptions:

(i) Prosecution in respect of cases involving offences relating to items i.e. FICN, arms, ammunitions and explosives, antiques, art treasures, wild life items and endangered species of flora and fauna may preferably be launched immediately after issuance of show cause notice.

(ii) If the party deliberately delays completion of adjudication proceedings, prosecution may be launched even during the pendency of the adjudication proceedings, where offence is grave and qualitative evidences are available [in view of the decision of Supreme Court in case of *Radhe Shyam Kejriwal 2011(266)ELT 294**.

Further, in following cases investigation may be completed in time bound manner preferably within **six months** and adjudication may be expedited to facilitate launching of prosecution. These cases are:

(A) Case where arrest has been made during investigation (for commercial fraud cases as well as outright smuggling cases) or in the case of a habitual offender.

(B) Case where arrest has not been made but it relates to outright smuggling of high value goods such as precious metal, restricted items or prohibited items notified under section 11 or goods notified under section 123 of the Customs Act, 1962 or foreign currency where the value of goods is ₹ 20 lakh or more.

[Circular No. 27/2015 Cus dated 23.10.2015]

Arrest

Pursuant to the enhancement in threshold limits for prosecution, threshold limits for arrest have also been enhanced vide *Circular No. 28/2015 Cus dated 23.10.2015*. Threshold limits for arrest are also the same as mentioned in case of initiating prosecution. It has been clarified that powers of arrest should be exercised in exceptional situation.

However, such threshold limit would not apply in case of offences relating to FICN, arms, ammunitions and explosives, antiques, art treasures, wild life items and endangered species of flora and fauna. In such cases, arrest, if required on the basis of facts and circumstances of the case, may be considered irrespective of value of offending goods involved.

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* The Supreme Court of India in the case of *Radhe Shyam Kejriwal 2011 (266) ELT 294 (SC)* had, *inter alia*, observed that

(i) adjudication proceedings and criminal proceedings can be launched simultaneously;

(ii) decision in adjudication proceedings is not necessary before initiating criminal prosecution;

(iii) adjudication proceedings and criminal proceedings are independent of each other in nature and

(iv) the findings against the person facing prosecution in the adjudication proceedings is not binding on the proceeding for criminal prosecution.

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Part II : Judicial Update – Indirect Tax Laws

Significant Recent Legal Decisions

"Select Cases in Direct and Indirect Tax Laws – An Essential Reading for the Final Course" is a compilation of the significant decisions of Supreme Court, High Court and Larger Bench of Tribunal. August, 2015 edition of the said publication is relevant for May, 2016 examination. Students may note that in addition to the cases reported in the said publication, following significant recent legal decisions are also relevant for May, 2016 examination:-

SECTION A: CENTRAL EXCISE

Basic Concepts

1. **Does printing on jumbo rolls of GI paper as per design and specification of customers with logo and name of product in colourful form, amount to manufacture?**

   CCE v. Fitrite Packers 2015 (324) ELT 625 (SC)

   Facts of the Case: The assessee purchased duty paid GI paper from the market and carried out printing on it according to the design and specifications of the customer. The printing was done on jumbo rolls of GIP twist wrappers. On the paper, logo and name of the product was printed in colorful form and the same was delivered to the customers in jumbo rolls without slitting. The customer intended to use this paper as a wrapping/packing paper for packing of their goods.

   Point of Dispute: Revenue contended that the process amounted to manufacture and the assessee was liable to pay excise duty thereon. However, the Tribunal, when the matter was brought before it, concluded that printing was only incidental and primary use of GI printing paper roll was for wrapping, which was not changed by the process of printing. Aggrieved by the Tribunal's order, the Revenue appealed before the Supreme Court.

   Supreme Court's Observations: The Supreme Court referred to one of its earlier judgments in the case of *Servo-Med Industries Pvt. Ltd. v. CCEx. 2015 (319) ELT 578*. In this case, the Apex Court had culled out four categories of cases to ascertain whether a particular process would amount to manufacture or not:

   (i) Where the goods remain exactly the same even after a particular process - There is obviously no manufacture involved. Process which remove foreign matter from goods complete in themselves and / or processes which clean goods that are complete in themselves fall in this category.

   (ii) Where the goods remain essentially the same after the particular process – Again there can be no manufacture. This is for the reason that the original article continues as such despite the said process and the changes brought about by the said process.

   (iii) Where the goods are transformed into something different and / or new after a particular process but the said goods are not marketable - No manufacture of goods

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takes place. Examples within this group are cases where the transformation of goods having a shelf life which is of extremely small duration.

(iv) Where the goods are transformed into goods which are different and / or new after a particular process and such goods are marketable as such - It is in this category that manufacture of goods can be said to take place.

The Apex Court observed that GI paper was meant for wrapping and its use did not undergo any change even after printing - the end use thereof was still the same namely wrapping / packaging. However, whereas the blank paper could be used as wrapper for any kind of product, after the printing of logo and name of the specific product thereupon, its end use got confined to only that particular and specific product of the particular company / customer. The printing, therefore, was not merely a value addition but had transformed the general wrapping paper to special wrapping paper.

Supreme Court's Decision: The Supreme Court held that the process of aforesaid particular kind of printing resulted into a product i.e., paper with distinct character and use of its own which it did not bear earlier. The Court emphasised that there has to be a transformation in the original article and this transformation should bring out a distinctive or different use in the article, in order to cover the process under the definition of manufacture. Since these tests were satisfied in the present case, the Apex Court held that the process amounted to manufacture.

CENVAT Credit

2. Is the assessee entitled to avail CENVAT credit of service tax paid on outward transportation of goods cleared from factory?

CCE v. Haryana Sheet Glass Ltd. 2015 (39) STR 0392 (P&H)

Facts of the Case: Assessee availed CENVAT credit of service tax paid on outward transportation of goods cleared from factory. The assessee was of the view that the transportation of goods from factory to the premises of the petitioner ought to be treated as input service. However, the Revenue disallowed the credit holding that the assessee was not entitled to credit of the service tax towards outgoing freight. The Appellate Tribunal, allowed the appeal of the assessee.

High Court's Decision: The High Court relied upon one of its earlier decision in the case of *Ambuja Cements Ltd. v. Union of India 2009 (236) ELT 431 (P&H)* and upheld the decision of the Tribunal.

The High Court held that outward transportation up to the place of removal falls within the expression "input service". The place of removal, in terms of the Circular* of the Board is a question of fact. If a manufacturer is to deliver the goods to the purchaser, the place of removal would not be a factory gate of the manufacturer but that of the purchaser. In the given case, there is no evidence that the property in goods stood transferred to the purchaser at the factory door of the assessee. Therefore, the assessee is entitled to avail CENVAT credit of service tax paid on outward transportation of goods cleared from factory.

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Note: *(1) The above case establishes that factory cannot necessarily be the place of removal in all cases. Only if the property in goods is transferred at factory gate, the sale will get complete at the factory gate, and then the factory will be considered as the place of removal.*

**(2) The circular referred to in the above case law was issued at an earlier point of time on 23.08.2007. However, a recent circular [Circular No. 988/12/2014 CX dated 20.10.2014] issued by the Board clarifies that the place of removal needs to be ascertained in term of provisions of Central Excise Act, 1944 read with provisions of the Sale of Goods Act, 1930. Payment of transport, inclusion of transport charges in value, payment of insurance or who bears the risk are not the relevant considerations to ascertain the place of removal. The place where sale has taken place or when the property in goods passes from the seller to the buyer is the relevant consideration to determine the place of removal.*

3. **Can a commercial training and coaching institute claim CENVAT credit in respect of the input services of catering, photography and tent services used to encourage the coaching class students, maintenance and repair of its motor vehicle and travelling expenses?**

Bansal Classes v. CCE & ST 2015 (039) STR 0967 (Raj.)

<u>Facts of the case</u>: The assessee is engaged in providing taxable commercial training and coaching services to students. It organises celebrations during the academic sessions whereby the services of catering, photography and tents are used. During these celebrations, students successful in coaching are rewarded so as to encourage the existing students and to motivate the new students. Further, it hires examination hall on rent basis for the purpose of conducting examination for students under the coaching. It also undertakes the maintenance and repair of vehicles used by it and incurs travelling expenses for the business tours.

It has availed CENVAT credit on the aforesaid services availed by it. However, Revenue alleged that CENVAT credit on such services was not admissible as these are not covered under the definition of input services under rule 2(l) of the CENVAT Credit Rules, 2004 since not used in/ in relation to providing output services.

When appealed before Tribunal, it held that assessee is eligible for CENVAT credit in respect of service tax paid on renting of immovable property service of hiring of examination hall, but disallowed the CENVAT credit availed with respect to other activities. The assessee appealed to High Court against the said order.

<u>High Court's observations</u>: The High Court agreed with the view taken by the Tribunal that once the students pass their coaching classes, the activities of catering, photography and tent services cannot be said to have been used to provide the output service of commercial training or coaching. Similarly, the assessee maintains and repairs its motor vehicle during the course of the business and there is no material to show that maintenance and repairs have any nexus to commercial training or coaching. Likewise, the travelling expenses incurred by assessee for the business tours cannot be related to provision of commercial training or coaching.

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<u>High Court's decision</u>: The High Court upheld the Tribunal's decision. Thus, the assessee is not eligible for CENVAT credit of the service tax paid on catering, photography and tent services, maintenance and repair of its motor vehicle and travelling expenses.

4. **Whether assessee is entitled to claim CENVAT credit of service tax paid on house-keeping and landscaping services availed to maintain their factory premises in an eco-friendly manner?**

Commr. of C. Ex., & S.T., LTU v. Rane TRW Steering Systems Ltd. 2015 (039) STR 13 (Mad.)

<u>Facts of the case</u>: Assessee had availed credit of service tax paid on house-keeping and gardening services. However, Revenue disallowed the credit and also imposed penalty on the ground that the assessee was not eligible to avail credit of service tax on these services.

<u>High Court's observations:</u> The High Court noted that principle enunciated in case of *CCE v. Millipore India Pvt. Ltd. 2012 (26) S.T.R. 514 (Kar.)* is applicable to the case on hand. In this case, the Karnataka High Court held that landscaping of factory or garden certainly would fall within the concept of modernization, renovation, repair, etc., of the office premises. At any rate, the credit rating of an industry is depended upon how the factory is maintained inside and outside the premises. The environmental law expects the employer to keep the factory without contravening any of those laws. That apart, now the concept of corporate social responsibility is also relevant. It is to discharge a statutory obligation, when the employer spends money to maintain their factory premises in an eco-friendly manner, certainly, the tax paid on such services would form part of the costs of the final products.

<u>High Court's decision</u>: The High Court agreeing with and following the ratio laid down in the aforesaid decision held that where an employer spends money to maintain their factory premises in an eco-friendly manner, the tax paid on such services would form part of the cost of the final products. Therefore, housekeeping and gardening services would fall within the ambit of input services and the assessee is entitled to claim the benefit of CENVAT credit on the same.

<u>Export Procedures</u>

5. **Whether rule 18 of Central Excise Rules, 2002 (CER) allows export rebate of excise duty paid on both inputs as well as the final product manufactured from such inputs?**

Spentex Industries Ltd v. CCE 2015 (324) ELT 686 (SC)

Rule 18 of CER stipulates that where any goods are exported, the Central Government may, by notification, grant rebate of duty paid on such excisable goods **OR** duty paid on material used in the manufacturing or processing of such goods. The issue in the instant

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case was that the word 'OR' used in between the two kinds of duties in respect of which rebate can be granted, postulates grant of one of the two duties or both the duties.

Supreme Court's Observations: The Apex Court made the following significant observations:

(i) Rules 18 and 19 of CER provide two alternatives to an exporter for getting the benefit of exemption from paying excise duty.

(ii) Under rule 19 of CER, the exporter is not required to pay any excise duty at all. When the exporter opts for this method, he is not required to pay duty either on the final product, i.e., on excisable goods or on the material used in the manufacture of those goods. The intention thus, is that goods meant for exports are free from any excise duty.

(iii) Once this scheme is kept in mind, it cannot be the intention of the Legislature to provide rebate only on one item in case a particular exporter opts for other alternative under rule 18, namely, paying the duty in the first instance and then claiming the rebate. Giving such restrictive meaning to rule 18 would not only be anomalous but would lead to absurdity as well and would defeat the very purpose of grant of remission from payment of excise duty in respect of export goods. It may also lead to invidious discrimination and arbitrary results.

(iv) The Central Government has issued necessary notifications under rule 18 for rebate in respect of both the duties, i.e., on intermediate product as well as on the final product. Further, and which is more significant, these notifications providing detailed procedure for claiming such rebates contemplate a situation where excise duty may have been paid both on the excisable goods and on material used in the manufacture of those goods and enable the exporter to claim rebate on both the duties.

(v) It is to be borne in mind that it is the Central Government which has framed the Rules as well as issued the notifications. If the Central Government itself is of the opinion that the rebate is to be allowed on both the forms of excise duties, the rule in question has to be interpreted in accordance with this understanding of the rule maker.

(vi) Though, the principle is that the word 'or' is normally disjunctive and 'and' is normally conjunctive, there may be circumstances where these words are to be read as *vice versa* to give effect to manifest intention of the Legislature as disclosed from the context.

The Supreme Court also referred to the order passed by the Revision Authority on the said issue (when the matter was brought before it vide a revision petition) wherein the Authority had held that the word 'OR' occurring in rule 18 cannot be given literal interpretation as that leads to various disastrous results. Therefore, 'or' has to be read as 'and' to carry out the objectives of the rule 18 and also to bring it at par with rule 19 and also because that is what was intended by the rule maker in the scheme of things.

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Supreme Court's Decision: The Supreme Court held that normally the two words 'or' and 'and' are to be given their literal meaning. However, wherever use of such a word, viz., 'and'/'or' produces unintelligible or absurd results, the Court has power to read the word 'or' as 'and' and *vice versa* to give effect to the intention of the Legislature which is otherwise quite clear. The Apex Court held that the exporters/appellants are entitled to both the rebates under rule 18 and not one kind of rebate.

Note: This case is in line with the Government's policy of neutralising the duty element (both Customs and Central Excise) on the goods exported with a view to promote exports of domestic products and make then internationally competitive.

This case overrules the Rajasthan High Court's decision in the case of Rajasthan Textile Mills v. UOI 2013 (298) ELT 183 reported in Select Cases in Direct and Indirect Tax Laws – 2015 [August 2015 Edition]. In this case, the High Court had held that under rule 18 of the Central Excise Rules, 2002, rebate can be claimed either on excisable goods or on materials used in the manufacture or processing of such goods i.e. on raw material, but not on both.

Exemption Based on Value of Clearances (SSI)

6. **Whether an assessee using a foreign brand name, assigned to it by the brand owner with right to use the same in India exclusively, is eligible for SSI exemption?**

   CCE v. Otto Bilz (India) Pvt. Ltd 2015 (324) ELT 430 (SC)

   Facts of the case: The assessee was availing the benefit of SSI exemption notification and was using a brand name 'BILZ' of a foreign company. The foreign company had assigned the said brand name in favour of the assessee under an agreement with right to use the said trade mark in India exclusively. The Revenue contended that since the assessee was using a brand name of a foreign company, it was ineligible to seek exemption under the aforesaid Notification.

   Supreme Court's Decision: The Supreme Court held that because of the aforesaid assignment, the assessee was using the trade mark in its own right as its own trade mark and therefore, it could not be said that it was using the trade mark of another person. The assessee was entitled to SSI exemption.

Notifications, Departmental Clarifications and Trade Notices

7. **Can the benefit of exemption notification be granted to assessee where one of the conditions to avail the exemption is not strictly followed?**

   CCE v. Honda Siel Power Products Ltd. 2015 (323) E.L.T. 644 (S.C.)

   Facts of the case: The assessee was availing the benefit of an exemption notification. One of the conditions to avail the benefit of said notification was that duty was to be paid in either of two modes of payment of duty – in cash or through account current. However,

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the assessee cleared the goods through utilization of CENVAT credit which was not the prescribed mode mentioned as per said condition.

Point of dispute: The issue which arose for consideration was as to whether the assessee was entitled to avail the benefit of said notification.

Supreme Court's Decision: The Apex Court observed that the assessee was required to fulfill the condition in *stricto senso* viz. to pay the duty either in cash or through account current if it wanted to avail the benefit of exemption notification and not through adjustment of CENVAT credit which was not the mode prescribed in the aforesaid condition. *It is trite that exemption notifications are to be construed strictly and even if there is any doubt same is to be given in favour of the Department.*

The Supreme Court held that once it is found that the conditions had not been fulfilled the obvious consequence would be that the assessee was not entitled to the benefit of said notification.

SECTION B: SERVICE TAX

Demand, Adjudication and Offences

8. **Can service tax be demanded by a speaking order without issuing a show cause notice but after issuing a letter and giving the assessee an opportunity to represent his case along with personal hearing?**

CCE v. Vijaya Consultants, Engineers and Consultants 2015 (040) STR 0232 (AP)

Facts of the Case: The Deputy Commissioner issued an order to the respondent demanding service tax. The appeal before the Commissioner (Appeals) challenging the order of the Deputy Commissioner ended up in dismissal confirming the order of the Deputy Commissioner. The CESTAT, on consideration of the arguments of the respondent and perusal of the record, found that the respondent was never issued a show cause notice as required under section 73 of the Finance Act, 1994. Hence the Tribunal set aside the order of the adjudicating authority. Aggrieved by this order, Revenue preferred appeal to High Court.

Appellant's (Revenue) Contentions: Revenue contended that the CESTAT was not justified in setting aside the speaking order passed by the competent adjudicating authority and confirmed by appellate authority, on the short ground of non-issuance of show cause notice as the respondent was suitably put on notice vide a letter. Thereafter the respondent had filed a 20 page explanation and fully utilized opportunity of personal hearing. The Revenue was of the view that since the respondent was afforded an opportunity of personal hearing before the case was decided, speaking order was passed after observing the principles of natural justice. Therefore, there was a substantial compliance on the part of the Revenue and the non-issuance of show cause notice was only a technical breach on their part.

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<u>Respondent's (assessee) Contentions:</u> The respondent submitted that there was a categorical finding of the Tribunal that there was fundamental breach of compliance of the statutory provision (i.e., non-issuance of SCN) which is the basic requirement to initiate the very proceedings under service tax law. Therefore, the order of the Tribunal was unassailable and did not call for any interference by this Court.

<u>High Court's Observations:</u> The High Court observed that a perusal of section 73 of the Finance Act, 1994 leaves no doubt that there is a requirement of issuance of notice stating whether the noticee falls within the category of section 73(1)(a) or 1(b) of the Act *[now section 73(1) and proviso to section 73(1)]* and further specify the amount of service tax that is payable.

The High Court observed that in the present case no notice was issued to the respondent and reliance was placed on a letter. The letter did not satisfy the requirements of the notice as there was no allegation that a specified amount was required to be paid as service tax and even no period was mentioned therein.

<u>High Court's Decision</u>: The High Court held that by no stretch of imagination, the said letter could be treated as a show cause notice satisfying the requirement of section 73 of the Act. The High Court further held that the procedural requirement of issuance of notice and calling for explanation cannot be dispensed with as otherwise the demand of money in the name of tax would be in violation of the very procedure prescribed under the Act. The High Court thus, dismissed the appeal.

9. **Based on the contractual arrangement, can the assessee ask the Department to recover the tax dues from a third party or wait till the assessee recovers the same?**

Delhi Transport Corporation v. Commissioner Service Tax 2015 (038) STR 673 (Del.)

<u>Facts of the Case</u>: The appellants entered into contracts with seven various agencies for display of advertisements, *inter alia*, on bus-queue shelters and time-keeping booths. The terms of the contract clearly stated that it would be the responsibility of the contractors/advertisers to pay directly to the concerned authority the tax/levy imposed by such authority in addition to the license fee.

The Department issued show cause notice asking the appellant to pay service tax along with interest and penalties on the service of display of advertisements rendered by them.

<u>Appellant's Contentions:</u> The appellant argued that they were under a *bona fide* belief that the liability to remit service tax stood transferred to the recipient qua the agreements; this caused the failure to file returns and remit service tax. They relied upon *Rashtriya Ispat Nigam Limited* v. *Dewan Chand Ram Saran 2012 (26) STR 289 (SC)* to urge that having entered into the contracts in the nature mentioned above, it was a legitimate expectation that the service tax liability would be borne by the contractors/advertisers and, thus, there was no justification for the appellant being held in default or burdened with penalties.

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<u>High Court's Observations:</u> The High Court observed that there is no dispute that services provided are taxable and that the appellant is liable to pay service tax thereupon. Further, the reliance of the appellant on *Rashtriya Ispat Nigam Limited's* case regarding transferring of service tax liability by way of a contract was correct. The High Court, however, observed that the said ruling of Supreme Court cannot detract from the fact that in terms of the statutory provisions it is the appellant which is to discharge the liability towards the Revenue on account of service tax.

The High Court agreed with the observations of CESTAT that the plea of "*bona fide* belief" is devoid of substance. The appellant was a public sector undertaking and should have been more vigilant in compliance with its statutory obligations. It could not take cover under the plea that contractors engaged by it having agreed to bear the burden of taxation, there was no need for any further action on its part. For purposes of the taxing statute, the appellant was an assessee, and statutorily bound to not only get itself registered but also submit the requisite returns as per the prescription of law and rules framed thereunder.

<u>High Court's Decision</u>: The High Court held that undoubtedly, the service tax burden can be transferred by contractual arrangement to the other party. However, on account of such contractual arrangement, the assessee cannot ask the Revenue to recover the tax dues from a third party (the other party) or wait for discharge of the liability by the assessee till it has recovered the amount from its contractors (the other party).

Note: In the case of Rashtriya Ispat Nigam Limited[1], the Supreme Court held that the provisions concerning service tax are relevant only between the appellant as an assessee (service receiver in this case) under the statute and the tax authorities. This statutory provision can be of no relevance to determine the rights and liabilities between the appellant and the respondent (service provider) as agreed in the contract between two of them. There was nothing in law to prevent the appellant from entering into an agreement with the respondent handling contractor that the burden of any tax arising out of obligations of the respondent under the contract would be borne by the respondent.

SECTION C: CUSTOMS

Levy of and exemptions from customs duty

10. In case of import of crude oil, whether customs duty is payable on the basis of the quantity of oil shown in the bill of lading or on the actual quantity received into shore tanks in India?

Mangalore Refinery & Petrochemicals Ltd v. CCus. 2015 (323) ELT 433 (SC)

<u>Facts of the Case</u>: The assessee imported crude oil. On account of ocean loss, the quantity of crude oil shown in the bill of lading was higher than the actual quantity

[1] Reported at page no. 178 of August, 2015 Edition of Select Cases in Direct and Indirect Tax Laws – 2015

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received into the shore tanks in India. The assessee paid the customs duty on the actual quantity received into the shore tanks.

Point of Dispute: The Department contended that the quantity of crude oil mentioned in the various bills of lading should be the basis for payment of duty, and not the quantity actually received into the shore tanks in India. This was stated on the basis that duty was levied on an *ad valorem* basis and not on a specific rate. The assessee contended that it makes no difference as to whether the basis for customs duty is at a specific rate or is *ad valorem*, inasmuch as the quantity of goods at the time of import alone is to be looked at.

Tribunal's Observations: The Tribunal accepted the Department's contentions on the basis of the following reasons:

(i) Duty ought to be levied on the total payment made by the assessee irrespective of the quantity received.

(ii) An *ad valorem* duty would necessarily lead to this result but duty levied at the specific rate would not. The quantity of goods to be considered in the latter case will only be the quantity of crude oil received in the shore tank.

(iii) Section 14 of the Customs Act, 1962 kicks in when the duty is on an *ad valorem* basis and sections 13 and 23 of the Act do not stand in the way because it is not the question of demanding duty on goods not received, but it is the demand of duty on the transaction value. In spite of the "ocean loss", the assessee has to make payment on the basis of the bill of lading quantity.

Supreme Court's Observations: The assessee raised the issue before the Supreme Court. The Apex Court noted the following:

(i) The levy of customs duty under section 12 of the Act is only on goods imported into India. Goods are said to be imported into India when they are brought into India from a place outside India. Unless such goods are brought into India, the act of importation which triggers the levy does not take place.

(ii) If the goods are pilfered after they are unloaded or lost or destroyed at any time before clearance for home consumption or deposit in a warehouse, the importer is not liable to pay the duty leviable on such goods. This is for the reason that the import of goods does not take place until they become part of the land mass of India and until the act of importation is complete which under sections 13 and 23 happen only after an order for clearance for home consumption is made and/or an order permitting the deposit of goods in a warehouse is made.

(iii) Under section 23(2), the owner of the imported goods may also at any time before such orders have been made relinquish his title to the goods and shall not be liable to pay any duty thereon. In short, he may abandon the said goods even after they have physically landed at any port in India but before any of the aforesaid orders have been made. This again is for the good reason that the act of importation gets complete when goods are in the hands of the importer after they have been cleared either for home consumption or for deposit in a warehouse.

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(iv) Further, as per section 47 of the Customs Act, the importer has to pay import duty only on goods that are entered for home consumption. Obviously, the quantity of goods imported will be the quantity of goods at the time they are entered for home consumption.

The Supreme Court stated that Tribunal's reasoning for concluding that the bill of lading quantity alone should be considered for the purpose of valuing the imported goods is incorrect in law. The Apex Court examined each of the reasons given by the Tribunal as under:

(i) The Tribunal lost sight of the fact that a levy in the context of import duty can only be on imported goods, that is, on goods brought into India from a place outside of India. Till that is done, there is no charge to tax.

(ii) The taxable event in the case of imported goods is "import". The taxable event in the case of a purchase tax is the purchase of goods. The quantity of goods stated in a bill of lading would perhaps reflect the quantity of goods in the purchase transaction between the parties, but would not reflect the quantity of goods at the time and place of importation. A bill of lading quantity, therefore, could only be validly looked at in the case of a purchase tax but not in the case of an import duty.

(iii) The Tribunal wholly lost sight of sections 13 and 23 of the Act. Where goods which are imported are lost, pilfered or destroyed, no import duty is leviable thereon until they are out of customs and come into the hands of the importer. It is clear, therefore, that it is only at this stage that the quantity of the goods imported is to be looked at for the purposes of valuation.

(iv) The basis of the judgment of the Tribunal is on a complete misreading of section 14 of the Customs Act. First and foremost, the said section is a section which affords the measure for the levy of customs duty which is to be found in section 12 of the said Act. Even when the measure talks of value of imported goods, it does so at the time and place of importation, which again is lost sight of by the Tribunal.

(v) The Tribunal's reasoning that somehow when customs duty is *ad valorem* the basis for arriving at the quantity of goods imported changes, is wholly unsustainable. Whether customs duty is at a specific rate or is *ad valorem* does not make the least difference to the statutory scheme. Customs duty whether at a specific rate or *ad valorem* is not leviable on goods that are pilfered, lost or destroyed until a bill of entry for home consumption is made or an order to warehouse the goods is made. This is for the reason that the import is not complete until what has been stated above has happened.

Supreme Court's Decision: The Supreme Court set aside the Tribunal's judgment and declared that the quantity of crude oil actually received into a shore tank in a port in India should be the basis for payment of customs duty.

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