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Chapter I : Income Tax - Basic Concepts

Problem 1

HSP Hotels Ltd. charges a nominal amount of Rs. 50 in each bill of the resident guests which is specifically earmarked only for the purpose of 'local charities'. This amount of Rs. 50 so collected in each bill is credited to a separate account named "Charity Account". The Assessing Officer doing assessment has issued a show cause notice to tax this amount of charity as income of the company. Discuss.

Answer

Since right from the inception, the amounts were impressed with an obligation in the nature of trust to be spent for charitable purposes only, these amounts were not its trading receipts. The guests paid the amount of Rs. 50 to the hotel separately for "Charities" which was in addition to the price / cost of the hotel room. Rs. 50 so collected was credited to a separate account named "Charity Account". The levy was clearly a payment collected for a specific purpose i.e., for 'local charities', and so the payments were validly earmarked for charity. Therefore, such amount credited to a separate "Charity" account would not form part of the price / cost of the hotel room.

Note

Where by an obligation, income is diverted before it reaches the assessee, it is not taxable in the hands of the assessee, since he is not actually entitled to it. However, an essential condition for non-taxability of income on the basis of the concept of "diversion of income" is the existence of a legal compulsion or contractual obligation or otherwise to do so. In this case, there appears to be no legal compulsion or contractual obligation or otherwise, requiring the assessee to earmark the amount of Rs. 50 collected in each bill to a separate account called "Charity account".

Therefore, it is possible to take a view that in the absence of any such legal compulsion or contractual obligation or otherwise, the crediting of the amount of Rs. 50 in each bill to a separate account is not diversion of income, but application of income by HSP Ltd. Consequently, if this view is taken, the action of the Assessing Officer in bringing to tax the amount of charity as income of the company would be in order.

Problem 2

Mr. Bhargava, a leading advocate on corporate law, decided to reduce his practice and to accept briefs only for paying his taxes and making charities with the fees received on such briefs. In a particular case, he agreed to appear to defend one company in the Supreme Court on the condition that he would be provided with Rs. 5 lacs for a public charitable trust that he would create. He defended the company and was paid the sum by the company. He created a trust of that sum by executing a trust deed. Decide whether the amount received by Mr. Bhargava is assessable in his hands as income from profession.

Answer

In the instant case, the trust was created by Mr. Bhargava himself out of his professional income. The client did not create the trust. The client did not impose any obligation in the nature of a trust binding on Mr. Bhargava. Thus, there is no diversion of the money to the trust before it became professional income in the hands of Mr. Bhargava. This case is one of application of professional income and not of diversion of income by overriding title. Therefore, the amount received by Mr. Bhargava is chargeable to tax under the head "Profits and gains of business or profession".

Problem 3

XYZ Ltd. took over the running business of a sole-proprietor by a sale deed. As per the sale deed, XYZ Ltd. undertook to pay overriding charges of Rs. 15,000 p.a. to the wife of the sole-proprietor in addition to the sale consideration. The sale deed also specifically mentioned that the amount was charged on the net profits of XYZ Ltd., who had accepted that obligation as a condition of purchase of the going concern. Is the payment of overriding charges by XYZ Ltd. to the wife of the sole-proprietor in the nature of diversion of income or application of income? Discuss.

Answer

This issue came up for consideration before the Allahabad High Court in Jit & Pal X-Rays (P.) Ltd. v. CIT. The overriding charge which had been created in favour of the wife of the sole-proprietor was an integral part of the sale deed by which the going concern was transferred to the assessee. The obligation was attached to the very source of income i.e. the going concern transferred to the assessee by the sale deed. The sale deed also specifically mentioned that the amount was charged on the net profits of the assessee-company and it had accepted that obligation as a condition of purchase of the going concern. Hence, it is clearly a case of diversion of income by an overriding charge and not a mere application of income.

Problem 4

MKG Agency is a partnership firm consisting of father and three major sons. The partnership deed provided that after the death of father, the business shall be continued by the sons, subject to the condition that the firm shall pay 20% of the profits to the mother. Father died in March, 20XX. In the next year, the reconstituted firm paid Rs. 1 lakh (equivalent to 20% of the profits) to the mother and claimed the amount as deduction from its income. Examine the correctness of the claim of the firm.

Answer

The issue raised in the problem is based on the concept of diversion of income by overriding title, which is well recognised in the income-tax law. Rs. 1 lakh, being 20% of profits of the firm, paid to the mother gets diverted at source by the charge created in her favour as per the terms of the partnership deed. Such income does not reach the assessee-firm. Rather, such income stands diverted to the other person as such other person has a better title on such income than the title of the assessee. The firm might have received the said amount but it so received for and on behalf of the mother, who possesses the overriding title. Therefore, the amount paid to the mother should be excluded from the income of the firm. This view has been confirmed in CIT vs. Nariman B. Bharucha & Sons.

Problem 5

"The illegality tainted with the income has no bearing on its taxability" – Elucidate this statement.

Answer

The statement is correct. The income-tax authorities are not concerned about the manner or means of acquiring income, and allowing tainted income to escape the tax net would be nothing but a premium or reward to the person for doing illegal trade. The Income-tax Act treats the income earned legally as well as illegal income alike. In the event of taxing the income of only those who acquire the same through legal manner, the tendency of those who acquire income by illegal means would increase. Therefore, even if the assessee has been prosecuted by the law enforcing authorities for commission of offence, the income earned by him would be an income liable for assessment. It would not be a defence in such cases that the State is also becoming a party to the illegal act by sharing the ill-gotten wealth. Therefore, illegality tainted with the earning has no bearing on its taxability.