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Income Tax

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INCOME TAX
(BCPCC303)

REVIEW COMMITTEE

Prof. Dr. Manjula Jain
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Teerthanker Mahaveer University (TMU)

Prof. Dr. Vipin Jain
Director, CDOE
Teerthanker Mahaveer University (TMU)

Prof. Amit Kansal
Associate Dean (Academics)
Teerthanker Mahaveer University (TMU)

Prof. Dr. Manoj Rana
Jt - Director, CDOE
Teerthanker Mahaveer University (TMU)

PROGRAMME COORDINATOR

Dr. Nitin Agarwal
Associate Professor
Department of Management and Commerce
Centre for Distance and Online Education (CDOE)
Teerthanker Mahaveer University (TMU)

BLOCK PREPARATION

Dr. Mohit Rastogi
Department of Management and Commerce
Centre for Distance and Online Education (CDOE)
Teerthanker Mahaveer University (TMU)

Secretarial Assistance and Composed By:
Mr. Namit Bhatnagar

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SYLLABUS

Taxation

Objectives:

- To provide in-depth knowledge of Income Tax Act, 1961 along with its latest provisions.
- To demonstrate an understanding of the rules associated with the reporting, calculation and payment of taxes.

S. No.	Description
1.	***Income Tax:*** Definitions, Capital and Revenue concepts and difference between both.
2.	***Basis of Charge:*** Residential status of person and scope of total income of person on the basis of residential status.
3.	Exempted Incomes under section 10.
4.	Computation of Income under the head Salaries.
5.	Computation of Income under the head House Property.
6.	Computation of Income under the head Business & Profession.
7.	Depreciation.
8.	Capital Gains.
9.	Income from Other Sources.

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Unit 1: Income Tax: Basic Framework

CONTENTS

Objectives

After studying this unit, you will be able to:

- Define Income tax
- Discuss the concept of Income
- Explore the concept of Capital and Revenue receipts
- List down the basic terminologies used in Income Tax
- Assess the overview of Income Tax Systems in India

Introduction

An income tax is a tax levied on the financial income of persons, corporations, or other legal entities. Various income tax systems exist, with varying degrees of tax incidence. Income taxation can be progressive, proportional, or regressive. When the tax is levied on the income of companies, it is often called a corporate tax, corporate income tax, or profit tax. Individual income taxes often tax the total income of the individual (with some deductions permitted), while corporate income taxes often tax net income (the difference between gross receipts, expenses, and additional write-offs). Every country generates income from 'Income-Tax' in the form of direct tax levied by government.

Income-tax plays a vital role in the economy of every country in the world. So, before one can embark on a study of the law of income-tax, it is absolutely vital to understand some of the expressions found under the Income-tax Act, 1961. The purpose of this Unit is to enable the students to comprehend basic expressions. Therefore, all such basic terms are explained and suitable illustrations are provided to define their meaning and scope.

1.1 Concept of Income Tax

Income tax is one of the forms of Direct Taxes. Tax is the financial charge imposed by the Government on income, commodity or activity. Government imposes two types of taxes namely Direct taxes and Indirect taxes. Direct tax is one where burden of tax is directly on the payer like for instance income tax, wealth tax etc. Indirect tax is paid by the person other than the person who utilizes the product or service like Excise duty, Custom duty, Service tax, Sales Tax, Value Added Tax.

The taxes are collected for serving the primary purpose of providing sufficient revenues to the State; taxes have come to be recognised as an instrument through which the social and economic objectives of a welfare State could be achieved. They are utilized now for providing incentives for larger earnings and more savings, fostering industrial development by selective concessions, restraining ostentatious expenditure, checking inflationary pressures and achieving social objectives like inequalities and the enlargement of opportunities to the common man.

Income-tax is one of the major sources of revenue for the Government. The responsibility for collection of income-tax vests with the Central Government. This tax is levied and collected under Income-tax Act, 1961. The Income-tax Act, in its present form came into force on and from 1st April, 1962. Before this, the Indian Income-tax Act, 1922 was in force. The procedural matters with regard to income-tax are governed by the Income-tax Rules, 1962, its earlier counterpart being the Income-tax Rules, 1922.

The Income tax Act contains the provisions for determination of taxable income, determination of tax liability, procedure for assessment, appeal, penalties and prosecutions. It also lays down the powers and duties of various income tax authorities.

Did u know? **Basic things about Income tax in India.**

Finance Act: Every year a Budget is presented before the parliament by the Finance Minister. One of the important components of the Budget is the Finance Bill. The Bill contains various amendments such as the rates of income tax and other taxes. When the Finance Bill is approved by both the houses of parliament and receives the assent of President, it becomes the Finance Act.

Notifications: The CBDT issue notifications from time to time for proper administration of the Income tax Act. These notifications become rules and collectively called Income Tax Rules, 1962.

Circulars: Circulars also issued by the CBDT to clarify the doubts regarding the scope and meaning of the provisions. These provisions are issued for the guidance of the Income Tax officers and assesses. These circulars are binding on the department, not on the assessee but assessee can take benefit of these circulars.

Judicial Decisions: Decisions pronounced by Supreme Court becomes law and they are binding on all the courts, Appellate Tribunal, Income Tax Authorities and on assesses while High Court decisions are binding on assesses and Income Tax Authorities which come under its jurisdiction unless it is overruled by a higher authority. The decision of a High Court cannot bind other High Court.

"*Income Tax is levied on the total income of the previous year of every person*."

Thus Income tax is a tax imposed by the Government of India on anybody who earns income in India.

Income earned in the twelve months contained in the period from 1st April to 31st March commonly referred to as Financial Year is taken into account for purposes of calculating Income Tax. Under the income tax Act this period is called a "Previous Year". Income earned in India is not limited to income earned within the geographical limits or boundaries of the country. Certain incomes are also deemed to have been earned in India although they may have been earned outside the country.

The word "Income" has a very broad and inclusive meaning. In case of a salaried person, all that is received from an employer in cash, kind or as a facility is considered as income. For a businessman, his net profits will constitute income. Income may also flow from investments in the form of Interest, Dividend, and Commission etc. Infect the Income Tax Act does not differentiate between legal and illegal income for purpose of taxation. Under the Act, all incomes earned by persons are classified into five different heads, such as:

- Income from Salary
- Income from House property
- Income from Business or Profession
- Income from capital gains
- Income from other sources

Therefore to levy income tax, one must have the understanding of the various concepts related to the charge of tax like previous year, assessment year, Income, total income, person etc. which is discussed in detail in the following sections.

Self Assessment

Fill in the blanks:

1. Income tax is one of the forms of ………………………..
2. ………………………..tax is paid by the person other than the person who utilizes the product or service.
3. Income-tax is one of the major sources of revenue for the ……………………………
4. ……………..contains various amendments such as the rates of income tax and other taxes.
5. Circulars also issued by…………………………. to clarify the doubts regarding the scope and meaning of the provisions.

1.2 Concept of Income

No precise definition of the word 'Income' is attempted under the Income Tax Act, 1961. The definition of Income as given in Section 2(24) of the Act starts with the word includes therefore the list is inclusive not exhaustive. The definition enumerates certain items, including those which cannot ordinarily be considered as income but are treated statutorily as such. Income includes not only those things which the interpretation clause declares. It shall also include all such things the word signifies according to its natural import.

> *Notes* Entry 82 of List I to the Seventh Schedule of the Constitution of India confers power on Parliament to levy taxes on income other than agricultural income.

As per section 2(24), the term 'income' means and includes:

1. Profits and gains;
2. Dividend;
3. Voluntary contributions: Voluntary contributions received by:
   - a trust created wholly or partly for charitable or religious purposes
   - a scientific research association; or
   - a fund or trust or institution established for charitable purposes and notified under section 10(23C)(iv) or (v) or
   - any university or other educational institution or by any hospital referred to in Section 10(23C)(iiad)(vi)(iiiae)(iva); or
   - an electoral trust.
4. The value of any perquisite or profit in lieu of salary taxable.
5. Any special allowance or benefit specifically granted to the assessee to meet expenses wholly, necessarily and exclusively for the performance of the duties of an office or employment of profit.
6. ***City Compensatory Allowance or Dearness allowance:*** Any allowance granted to the assessee either to meet his personal expenses at the place where the duties of his office or employment of profit are ordinarily performed by him or at a place where he ordinarily resides or to compensate him for the increased cost of living.
7. ***Benefit or Perquisite to a Director:*** The value of any benefit or perquisite, whether convertible into money or not, obtained from a company by: (a) a director, or (b) a person having substantial interest in the company, or (c) a relative of the director or of the person having substantial interest, and any sum paid by any such company in respect of any obligation which, but for such payment, would have been payable by the director or other person aforesaid.
8. ***Any Benefit or perquisite to a Representative Assessee:*** The value of any benefit or perquisite (whether convertible into money or not) obtained by any representative assessee under Section 160(1)(iii)/(iv) or beneficiary, or any amount paid by the representative assessee in respect of any obligation which, but for such payment, would have been payable by the beneficiary.
9. Any sum chargeable under section 28, 41 and 59 like:
   - any sum chargeable to tax as business income under Section 28(ii), any amount taxable in the hands of a trade, professional or similar association (for specific services performed for its members) as its income from business under Section 28(iii), and deemed profits which are taxable under Sections 41 and 59 of the Act;
   - any sum chargeable to income-tax under clause (iiia) of Section 28, i.e. profits on sale of a licence granted under the Imports (Control) Order, 1955, made under the Imports and Exports (Control) Act, 1947 [inserted by the Finance Act, 1990, with retrospective effect from 1.4.1962];

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- any sum chargeable to income-tax under clause (iiib) of Section 28 i.e., cash assistance (by whatever name called), received or receivable by any person against exports under any scheme of the Government of India;
- any sum chargeable to income-tax under clause (iiic) of Section 28 i.e., any duty of customs or excise re-paid or re-payable as drawback to any person against exports under the Customs and Central Excise Duties Drawback Rules, 1971;
- the value of any benefit or perquisite whether convertible into money or not; taxable as income under Section 28(iv) in the case of person carrying on business or exercising a profession;
- any sum chargeable to income-tax under clause (v) of Section 28.

10. ***Capital Gain:*** Any capital gains chargeable to tax under Section 45; since the definition of income in Section 2(24) is inclusive and not exhaustive capital gains chargeable under Section 46(2) are also assessable as income.
11. ***Insurance Profit:*** The profits and gains of any business of insurance carried on by a mutual insurance company or by a co-operative society computed in accordance with the provisions of Section 44 or any surplus taken to be such profits and gains by virtue of the profits contained in the First Schedule to the Income-tax Act.
12. ***Banking income of a Co-operative Society:*** The profits and gains of any business of banking (including) providing credit facilities carried on by a cooperative society with its members.
13. Winnings from Lottery: any winnings from lotteries, crossword puzzles, races, including horse-races, card-games and games of any sort or from gambling or betting of any form.
    - "lottery" includes winnings, from prizes awarded to any person by draw of lots or by chance or in any other manner whatsoever, under any scheme or arrangement by whatever name called;
    - "card game and other game of any sort" includes any game show, an entertainment programme on television or electronic mode, in which people compete to win prizes or any other similar game.
14. ***Employees Contribution towards Provident Fund:*** Any sum received by the assessee from his employees as contributions to any provident fund or superannuation fund or any fund set-up under the provisions of the Employees State Insurance Act, 1948 (34 of 1948) or any other fund for the welfare of such employees.
15. ***Amount Received under Keyman Insurance Policy:*** Any sum received under a Keyman Insurance Policy including the sum allocated by way of bonus on such policy. Keyman Insurance Policy means a life insurance policy taken by a person on the life of another person who is or was the employee of the first mentioned person or is or was connected with the business of the first mentioned person in any manner whatsoever.
16. ***Amount Received for not Carrying out any Activity:*** Any sum referred to in Section 28(va), i.e. any sum, whether received or receivable in cash or kind, under an agreement for:
    - not carrying out any activity in relation to any business; or
    - not sharing any know-how, patent, copyright, trade-mark, license, franchise or any other business or commercial right of similar nature or information or technique likely to assist in the manufacture or processing of goods or provision for services.
17. ***Gift received for an Amount Exceeding ₹ 50,000:*** Any sum of money or value of property referred to in clause (vii) or clause (viia) of sub-section (2) of Section 56.

18. ***Consideration Received for Issue of Shares:*** Any consideration received for issue of shares as exceeds the fair market value of the shares referred in section 56(2)(viib).

1.2.1 Features of Income

In general terms, Income is a periodical monetary return with some sort of regularity. However, the Income Tax Act, even certain income which does not arise regularly is treated as income for tax purposes for instance income earned from Winnings of lotteries or crossword puzzles etc. A study of some of the broad principles given below will help you to understand the concept of income:

1. ***Cash or Kind:*** Income may be received in cash or kind. When the income is received in kind, its valuation will be made in accordance with the rules prescribed in the Income-tax Rules, 1962.
2. ***Receipt Basis or Accrual Basis:*** Income arises either on receipt basis or on accrual basis. It may accrue to a taxpayer without its actual receipt. The income in some cases is deemed to accrue or arise to a person without its actual accrual or receipt. Income accrues where the right to receive arises.
3. ***Temporary or Permanent:*** There is no difference between temporary and permanent income under the Act. Even temporary income is taxable same as permanent income.
4. ***Lumpsum or Instalments:*** Income whether received in lump sum or in instalments is liable to tax. For example: arrears of salary or bonus received in lump sum are income and charged to tax as salary.
5. ***Gifts:*** Gifts of personal nature do not constitute income subject to maximum of ₹ 50,000 received in cash. The recipient of gifts like birthday, marriage gifts, etc., is not liable to income-tax as received in kind however as per the Finance Act, 2009 gifts in kind having fair value upto ₹ 50,000 is not liable to tax but having fair value of more than ₹ 50,000 is wholly taxable.
6. ***Revenue or Capital Receipt:*** Income-tax, as the name implies, is a tax on income and not a tax on every item of money received. Therefore, unless the receipt in question constitutes income as distinguished from capital, it cannot be charged to tax. For this purpose, income should be distinguished from capital which gives rise to income. However, some capital receipts have been specifically included in the definition of income.
7. ***Definite Source:*** Income has been compared with a fruit or a crop from the field. Fruit comes from a tree and crop from fields. Thus, the source of income is definite in both the cases. The existence of a source for income is somewhat essential to bring a receipt under the charge of tax.
8. ***Income must Come from Outside:*** No one can earn income from himself. There can be no income from transaction between head office and branch office. Contributions made by members for the mutual benefit and found surplus cannot be termed as income of such group.
9. ***Tainted Income:*** Income earned legally or illegally remains income and it will be taxed according to the provisions of the Act. Assessment of illegal income of a person does not grant him immunity from the applicability of the provisions of other act.
10. ***Voluntary Receipt:*** The receipts which do not arise from the exercise of a profession or business or do not amount to remuneration and are made for reasons purely of personal nature are not included in the scope of total income.

1.2.2 Tax Treatment of Income

Notes

For the purposes of treatment of income for tax purposes it can be divided into three categories:

1. ***Taxable Income:*** These incomes from part of total income and are fully taxable. These are salaries, rent, business profits, professional gains, capital gain, and interest dividend and so on.
2. ***Exempted Income:*** These incomes do not from part of total income either fully or partially. Hence, no tax is payable on such incomes.
3. ***Rebateable (Tax Free Incomes):*** These incomes form part of total income and are fully taxable. Tax is calculated on total income out of which a Rebate of Tax at average rate is allowed.

Caselet

Vodafone Wins Tax Case in SC; Deal with Hutchison 'Bonafide'

Vodafone on Friday got relief in its income tax case after the Supreme Court ruled its deal with Hutchison as 'bonafide'. The Supreme Court on Friday in a majority verdict has upheld Vodafone International Holdings BV's contention that the Income Tax department did not have jurisdiction over a $11.2 billion deal in May 2007 in which the British group acquired Hutchison Telecommunications International as part of a complex transaction to buy the latter's majority stake in its Indian telecom business. The Indian unit, called Hutchison Essar then, is today named Vodafone Essar.

The verdict has asked the tax department to return the ₹ 2,500 crore that Vodafone had submitted as interim tax liability.

The verdict sets aside the uncertainty over the tax claim on Vodafone, as also companies involved in such transactions, but in future similar deals may come under the ambit of the proposed Direct Tax Code (DTC), which is being currently debated in Parliament. It taxes similar deals subject to certain conditions.

The telecom giant had moved the apex court challenging the Bombay High Court judgement of September 8, 2010 which had held that Indian I-T department had jurisdiction over the deal.

Through the $11.2 billion deal in May 2007, Vodafone acquired 67 per cent stake in the Hutchison-Essar Ltd (HEL) from Hong Kong-based Hutchison Group through companies based in Netherlands and Cayman Island.

The I-T Department maintained that since capital gains were made in India through the deal, Vodafone was liable to pay the tax and issued a showcause notice to it, asking as to why it should not be treated as a representative assessee of the Vodafone International Holding.

Vodafone, however, challenged the show cause notice before the Bombay High Court saying it was share transfer carried outside India.

The appeal was rejected by the high court in December 2008 which was again challenged by Vodafone before the apex court.

Source: http://businesstoday.intoday.in/story/vodafone-wins-tax-case-in-supreme-court/1/21814.html

Self Assessment

State whether the following statements are true or false:

6. Entry 82 of List I to the Eighth Schedule of the Constitution of India confers power on Parliament to levy taxes on income other than agricultural income.
7. Income is a periodical monetary return with some sort of regularity.
8. Income arises either on receipt basis or on accrual basis.
9. There exists a difference between temporary and permanent income under the Income Tax Act.
10. Gifts of personal nature do not constitute income subject to maximum of ₹ 50,000 received in cash.

1.3 Concept of Capital and Revenue Receipts

Income Tax is levied on income of assessee and not an every receipt which he receives. The method of charging tax on different types of receipt is different. Income tax Act, 1961 provides a separate head "Capital Gains" for levying tax on capital receipts. Similarly, while calculating net taxable income of assessee only revenue expenses are allowed to be deducted out of revenue receipts. Particularly while calculating business profit or professional gain only revenue receipts and revenue expenses are considered. This makes the distinction between capital and revenue of vital importance. For this distinguish, capital and revenue items can be divided in to three sub-parts:

1. Capital Receipts vs Revenue Receipts
2. Capital Expenses vs Revenue Expenses
3. Capital Losses vs Revenue Losses

1.3.1 Capital Receipt vs Revenue Receipts

As stated above the capital receipts are to be charged to tax under "Capital Gains" and revenue receipts are taxable under other heads, it is of vital importance to understand which receipt is a capital receipt and which one is Revenue. Some tests, however, can be applied in particular cases. These tests are:

1. ***On the basis of nature of assets:*** If a receipt is referred to Fixed Asset, it is capital receipt and if it is referred to as circulating asset than it is revenue receipt. Fixed assets is that with the help of which owner earns profit by keeping it in this possession, like. Plant, Machinery, Building or factory etc. Circulating Asset is that with help of which owner earns profits by parting with it and letting others to become its owner, e.g. Stock-in Trade. Profit on the sale of Motor Car used in business by an assessee is Capital Receipt whereas the profit earned by an automobile dealer, dealing in cars, by selling a car is his revenue receipt.
2. ***Termination of source of income:*** Any sum received in compensation for the termination of source of income is capital receipt, e.g. compensation received by an employee from its employer on termination of his services is capital receipt.
3. ***Amount received in substitution of income:*** Any sum received in substitution of income is revenue receipt like. 'A' company purchased the right to produce a Film from its earlier producer with the condition that no other produce will be given these rights. Afterwards, it is found that the rights for producing this film had already been sold. The 'A' Company claimed damages and was awarded ₹ 50, 000. It was held that damages received are the compensation for the profits which were to be earned. Hence, this is Revenue Receipt.

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4. ***Compensation received on termination of lease or surrender of a Right:*** Any amount received as compensation on surrendering a right or termination of any Lease is Capital Receipt where as any amount received for loss of future income is a revenue receipt. For instance an author gives up his right to publish a book and receives ₹ 1,00,000 as compensation. It is capital receipt but if he receives it as advance Royalty for 5 years it is Revenue receipt.

Notes **Capital and Revenue Receipts in Relation to Business Activities**

Profits and gains arising from the various transactions which are entered into the ordinary course of the business of the tax payers or those which are incidental to or closely associated with his business would be revenue receipts chargeable to tax.

Examples of these types of receipts are:

- profits on purchase and sale of shares by a share broker on his own account;
- profits arising from dealings in foreign exchange by a banker or other financial institutions,
- income from letting out buildings owned by a company to its employees etc.

But even in these cases the receipts may be of a capital nature in certain circumstances.

For instance, profit on sale of shares and securities held by a bank as investments would be of a capital nature. Where profits arise from transactions which are outside the normal dealing of the assessee, although connected with his business, the taxable nature or otherwise of the profits would depend upon the fact whether or not the transactions in question constitutes trading activity.

Examples of Differentiation between Capital Receipts and Revenue Receipts

The following are the few examples of differentiation between capital receipts and revenue receipts:

1. ***Taxable income in relation to annuities:*** Annuities are periodic payments of specified amounts at regular intervals of time. Annuities are revenue receipts taxable as income in every case although the payment of the annuity involves the conversion of capital into income. The contingent or variable nature of the annuity, its amount, periodicity, mode of payment etc. does not, in any way, affect the taxability of the annuity. An annuity received by an employee from his present or previous employer would be taxable as his income from salaries while all other annuities are taxable as income from other sources. Although annuities are generally annual payments, every annual payment does not represent an annuity.

   For instance annual instalments of capital payments do not constitute annuities. Thus, when a person sells his business or property and agrees to receive the consideration in instalments annually or half-yearly, the amounts received by him are merely capital sums received in instalments and are, therefore, not taxable as annuities. But if the same property is sold for an annuity payable at regular intervals immediately on sale the property disappears and the right to get annuity takes place; the annuities received by virtue of the right acquired on sale would be taxable as income.

   On the other hand, a lump sum payment received in commutation of salaries or pension, even though a capital receipt would be taxable as salary income. Similarly, any amount received under a policy of insurance would be a revenue receipt if the policy was held by

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the assessee as a trading asset whereas it would be a capital receipt if the policy was held as a capital asset.

2. ***Taxable income vis-a-vis compensation:*** Compensation for termination of a sole selling agency is a capital receipt although it is taxable as business income by virtue of the specific provision in Section 28 of the Act, but if an assessee has many agencies and one of them is terminated, the compensation received by the assessee would be a revenue receipt; the fact that it is taxable as business income even otherwise does not convert the character of the receipt from revenue to capital. The compensation received for restraint of trade or profession is a capital receipt since it is received in replacement of the source of income itself. But this principle does not apply to cases where the restraint of trade or profession is incidental to (and is not the primary purpose) the agreement between the parties. For instance, non-practicing allowance received by a doctor from his employer as an integral part of the terms of employment would be taxable as his salary income since it does not represent a capital receipt. Therefore, the taxability of compensation in all cases would depend upon whether it is received in replacement of the main source of income itself or in replacement of the income. If it is the former, it is a capital receipt; in the latter case, it would be revenue.

3. ***Taxable income vis-a-vis subsidies and grants:*** Subsidies and grants received from the government would generally be receipts of a revenue nature since they are intended to supplement the income of the assessee. But in cases where the grant is received for a specific purpose but not as a supplementary trading receipt it would be a capital receipt not taxable as income. For instance, if a company is given grant to undertake work to relieve unemployment or to promote family planning the grant being received for a specific purpose would constitute capital receipt exempt from tax.

4. ***Taxable income vis-a-vis debenture:*** For debenture holder the premium on redemption or the discount on issue of the debentures by the company would be a capital receipt and would not consequently be liable to tax. In the case of the issuing company also, the premium or discount on the issues of shares and debentures or on their redemptions would be on capital account. But the discount on loans advanced at a discount and repayable at a premium would be a revenue receipt in the hands of a person whose business is that of money-lending if the loans had been advanced in the ordinary course of the assesses business without taking any extra commercial consideration as the cases. In all other cases, such a discount would be on capital account. However, the premium (salami) – a single payment made for the acquisition by the lessee of the right to occupy and enjoy the benefits granted to him under the lease of any land, building or other capital asset – is normally a capital receipt since the rights acquired or given under the lease by virtue of the payment of salami constitute a capital asset. But if the premium takes the character of advance rent (instead of the price paid for parting with and giving possession of the capital asset) the receipt would be taxable as income.

5. ***Taxable income vis-a-vis royalties:*** Royalties in every case are taxable as income from other sources; it is immaterial whether they are received in lump sum or as fixed annual sum or otherwise; the basis of computation of the royalties would be equally immaterial. The taxability of the royalty does not also depend upon the nature of the asset the use of which gives rise to the royalty; the asset may be a patent, copyright, goodwill, technical know-how, secret formula or process and so on. If, however, the receipt is in consideration of the assignment, sale or surrender of the patent, copyright, etc. (but not the use thereof) the owner of the asset would cease to be its owner as soon as the assignment, sale or surrender takes place and therefore, the receipt would constitute a capital receipt.

6. ***Taxable income vis-a-vis devaluation in foreign currency:*** Profit arising from devaluation of a currency or dealings in foreign exchange and that attributable to the normal fluctuations

in the rate of exchange of currencies would be receipts of a revenue nature taxable as income in cases where the foreign currencies are held as stock in trade by the assessee (e.g. a bank or a dealer in the foreign exchange). Where the foreign currencies are held as capital assets representing the assessee's investments the profit or loss would be on capital account.

Did u know? **Exceptions where capital receipt are taxable**

Although the general principle of law is to tax only revenue receipts as income, there are three exceptions to this rule under which capital receipts are also taxable as income, viz.:

(i) Any compensation received for termination of employment or modification of the terms of employment would fall within the meaning of a profit in lieu of salary and consequently taxable as salary income. [Section 17(3)(i)]

(ii) Any compensation received for termination of managing agency or other contractual relationship in relation to the management of whole or substantially the whole of the affairs of a company or the modification of the terms and conditions relating thereto would be taxable as income from business. [Section 28(ii)(a and b)]

(iii) Any compensation or other payment due to or received by any person for the termination or the modification of the terms of any other agency held by him in India in relation to the business of any other person would also be taxable as income from business regardless of the nature of the agency business. [Section 28(ii)(c)].

1.3.2 Capital Expenses vs. Revenue Expenses

To distinguish a Revenue Expenditure from a Capital Expenditure, the following tests can be applied for this purpose:

1. ***Nature of the Assets:*** Any expenditure incurred to acquire a Fixed Assets or in connection with installation of Fixed Assets is Capital Expenditure. Whereas any expenditure incurred as price of goods purchased for resale along with other necessary expenses incurred in connection with such purchase are Revenue Expense.

2. ***Nature of Liability:*** A payment made by a person to discharge a capital liability is a capital expenditure. Whereas an expenditure incurred to discharge a revenue liability is Revenue Expenditure, like Amount paid to a contractor for cancellation of contract to construct a factory building is capital expenditure.

3. ***Nature of Transaction:*** If expenditure is incurred to acquire a source of income, it is Capital Expenditure for instance like purchase of patents to produce picture tubes of T.V. sets. Whereas expenditure incurred to earn an income is revenue expenditure, e.g. salary to staff, advertisement expenses, etc.

4. ***Nature of Payment in the Hands of Payer:*** If expenditure is incurred by an assessee as a Capital Expenditure, it will remain a capital expenditure even if the amount may be revenue receipt in the hands of receiver, such as purchase of Motor Car by a businessman is capital expenditure in his hands although it is revenue receipt in the hands of car dealer.

1.3.3 Capital Losses vs Revenue Losses

Distinction has to be made between revenue losses and capital losses of the business because under the provisions of this Act Capital Losses are dealt with under the Chapter "Capital Gain" whereas Revenue Looses are treated as Business Losses and as such are treated under the head "Profit and Gains of Business or Profession".

Distinguish has to be made between Revenue Losses and Capital Losses of the business because under the provisions of this Act, Capital Losses can be set off against the Income from Capital Gain only, whereas the Revenue Losses are business losses and as such can be set off against any other income of the assessee.

It is very difficult to distinguish between a Capital Loss and a Revenue Loss on the basis of certain principles. On the basis of court judgment, following decisions have become distinguishing points:

1. ***Loss due to sale of assets:*** Where there is loss on selling Capital Assets, it is a Capital Loss whereas any loss incurred during the sale of Stock-in-Trade is a Revenue Loss.
2. ***Loss due to embezzlement:*** Where there is embezzlement done by an employee and this causes loss to the business, it is of Revenue Loss.
3. ***Loss due to withdrawal of money from bank:*** Once the amount is deposited in Bank and then it is withdrawn by an employee and is misappropriated, is a Capital Loss.
4. ***Loss due to liquidation of company:*** Amount deposited by a person with manufacturing industry to get its agency and lost due to company being liquidated is a Capital Loss.
5. ***Loss due to theft by an employee:*** Losses occurring due to theft or embezzlement of misappropriation committed by an employee is Revenue Loss.

Example: State, giving reasons, whether the following are Capital or Revenue Receipts:

1. Compensation received for compulsory vacation of place of business.
2. Bonus shares received by a dealer of shares.
3. Money received by a Tyre Manufacturing company for sale of technical know-how regarding manufacture of Tyre.
4. Dividend and interest for investment.

Solutions:

1. Revenue receipt as it is in compensation of assessee's profit which it would have earned.
2. If the assessee has also converted the bonus shares into stock in trade then it is a revenue receipt otherwise it is an accretion in the capital assets.
3. Revenue Receipt, but in case the sale of technical know-how results into substantial reduction in value of the Tyre company or company closes down its business in that particular line then the receipt would be a Capital Receipt.
4. Assessee gets the income of dividend and interest regularly and form a define source and it is a return for the use of his asset by somebody else and so it is a revenue receipt.

Factors that do not Determine the Nature or Character of Receipt

The capital or revenue nature of a receipt must be determined with reference to each receipt on the basis of the facts and circumstances of each case, the ultimate conclusion as to the capital or revenue character of the receipt would be of the High Court or the Supreme Court and the principles laid down by the Court must be followed for the purpose. However, while determining the question whether a particular receipt is capital or revenue in nature, care must be taken to ensure that the following are not taken as the basis for determination although these factors may, to a certain extent, is helpful to arrive at the conclusion:

1. ***Character and source of income:*** The nature of receipt should be decided entirely on the basis of its character in the hands of the recipient, the source from which the payment has been received being immaterial for the purpose. For instance, there may be cases where the payer makes the payment out of capital while the recipient gets it as income. This may happen in cases like the payment of interest out of capital under Section 208 of the Companies Act, 1956 which the recipient gets as income chargeable to tax. Another instance would be of a businessman who deals in plant and machinery; while the purchaser of the machinery would pay the price out of his capital, the seller would get it as income from business. Therefore, the taxability of the receipt does not depend upon the character of payment in the hands of the payer.

2. ***Application of income:*** The application of the income after its receipt by the recipient is also immaterial for purposes of taxability.

3. ***Allowance or disallowance of the amount to the payer:*** The payment may represent expenditure in the hands of the payer and in certain cases may be disallowed in computing the taxable income of the payer. But the disallowance in the payer's hands would not in any way affect the taxability of the entire amount of remuneration in the employees or directors hands although there may be double taxation of the same amount in two hands for the same period. Thus, the allowance or disallowance of the amount to the payer is immaterial for taxing the recipient.

4. ***Treatment given in the books:*** The name by which the payment is called by the parties concerned and the treatment given to it in the books of accounts of the parties would also be irrelevant. For instance, every item of income from employment is taxable as salary income whether it is called salary, wages, bonus, pension, and annuity or by any other name. In other words, it is only the real character of the receipt and not what the parties call it that would determine its taxability.

5. ***Magnitude and method of payment:*** The quantum of the payment, whether it is paid in instalments or in lump sum and also whether it is paid at regular intervals of time or otherwise and even the magnitude of the payment are not the factors that determine the capital or revenue character of the receipt for tax purpose.

6. ***Basis for measurement of the receipt:*** The basis for measurement of the receipt (a specified percentage of the estimated profit taken as the basis for measuring damages) should not be taken as the deciding factor for determining the capital or revenue character of the receipt.

7. ***Ways or devices resorted by payer:*** The various devices resorted to by tax payers in arranging their financial affairs do not also conclusively establish the nature of the receipt because a tax payer is legally entitled to arrange his affairs in such a way as to reduce his tax burden to the minimum. In the light of the aforesaid principles the capital or revenue nature of the receipt should be first determined before proceeding to compute the taxable income.

Example: The following examples will help you to understand whether the concept of capital or revenue receipts or expenses and giving reasons:

1. AB & Co. received ₹ 2, 00,000 as compensation from CD & Co. for premature termination of contract of agency.

2. Sales-tax collected from the buyer of goods.

3. PQ Company Ltd. instead of receiving royalty year by year received it in advance in lump sum.
4. An amount of ₹ 1, 50,000 were spent by a company for sending its production manager abroad to study new methods of production.
5. Payment of ₹ 50,000 as compensation for cancellation of a contract for the purchase of machinery with a view to avoid an unnecessary expenditure.
6. An employee director of a company was paid ₹ 1, 75,000 as a lump sum consideration for not resigning from the directorship.

Solutions:

1. Receipt in substitution of a source of income is a capital receipt. Therefore, the amount received by AB & Co. from CD & Co. for premature termination of an agency contract is a capital receipt though the same is taxable under Section 28(ii)(c).
2. Sales-tax is the liability of a seller to pay to the Government on the sale of goods made by him, which is allowed as deduction as revenue expenditure. If any part of Sales-tax is collected from the buyer of goods that may be treated as a revenue receipt. Thus the sales-tax collected from the buyer of goods is a revenue receipt.
3. Receipt of lump sum royalty in lieu of future royalties is a revenue receipt, as it is an income from royalty.
4. Amount spent by a company for sending its production manager abroad to study new methods of production is revenue expenditure to be allowed as a deduction. Because of the new knowledge and its exposure the manager will assist the company in improving its existing methods of production etc.
5. This is a capital expenditure, as any expenditure incurred by a person to free himself from a capital liability is a capital expenditure. In the given case, the payment of ₹ 50,000 for cancelation of the order of purchase of machinery, has helped the assessee to become free from an unnecessary capital liability.
6. The amount of ₹ 1, 75,000 received for not resigning from the directorship is a reward received from the employer. Therefore it is a revenue receipt.

Self Assessment

Fill in the blanks:

11. Income tax Act, 1961 provides a separate head ……………………… for levying tax on capital receipts.
12. If a receipt is referred to Fixed Asset, it is ……………………….
13. If a receipt is referred to Circulating Asset, it is ……………………….
14. ……………………….are periodic payments of specified amounts occurring at regular intervals of time.
15. ………………………received from the government would generally be receipts of a revenue nature since they are intended to supplement the income of the assessee.

1.4 Basic Concepts of Income Tax

Section 2 of the Act gives definitions of the various terms and expressions used therein. In order to understand the provisions of the Act, one must have a thorough knowledge of the meanings of certain key terms like 'person', 'assessee', 'income', etc. To understand the meanings of these terms we have to first check whether they are defined in the Act itself. If a particular definition is given in the Act itself, we have to be guided by that definition. If a particular definition is not given in the Act, reference can be made to the General Clauses Act or dictionaries. Students should note this point carefully because certain terms like "dividend", "transfer", etc. have been given a wider meaning in the Income-tax Act, 1961 than they are commonly understood.

Some of the important terms defined under section 2 are given below:

(1) ***Assessee [Section 2(7)]:*** 'Assessee' means a person by whom any tax or any other sources of money is payable under this act, and includes:

  (a) Every person in respect of whom any proceedings under this act have been taken for the assessment

  - of his income or of the income of any other person in respect of which he is assessable; or
  - of the loss sustained by him or by such other person; or
  - of the amount of refund due to him or to such other person;

  (b) Every person who is deemed to be an assessee under any provision of this Act.

  (c) Every person who is deemed to be an assessee in default under any provisions of this act.

(2) ***Person [Section 2(31)]:*** The definition of 'assessee' leads us to the definition of 'person' as the former is closely connected with the latter. The term 'person' is important from another point of view also viz., the charge of income-tax is on every 'person'.

  The definition is inclusive i.e. a person includes,

  (a) an individual,

  (b) a Hindu Undivided Family (HUF),

  (c) a company,

  (d) a firm,

  (e) an AOP or a BOI, whether incorporated or not,

  (f) a local authority, and

  (g) every artificial juridical person e.g., an idol or deity.

  We may briefly consider some of the above seven categories of assessees each of which constitute a separate unit of assessment.

  (i) *Individual:* The term 'individual' means only a natural person, i.e., a human being. It includes both males and females. It also includes a minor or a person of unsound mind. But the assessment in such a case may be made under section 161(1) on the guardian or manager of the minor or lunatic. In the case of deceased person, assessment would be made on the legal representative.

(ii) *HUF:* Under the Income-tax Act, a Hindu Undivided Family (HUF) is treated as a separate entity for the purpose of assessment. It is included in the definition of the term "person" under section 2(31). The levy of income-tax is on "every person". Therefore, income-tax is payable by a HUF. "Hindu undivided family" has not been defined under the Income-tax Act. The expression is however defined under the Hindu Law as a family, which consists of all males lineally descended from a common ancestor and includes their wives and unmarried daughters. The relation of a HUF does not arise from a contract but arises from status.

A Hindu is born into a HUF. A male member continues to remain a member of the family until there is a partition of the family. After the partition, he ceases to be a member of one family. However, he becomes a member of another smaller family. A female member ceases to be a member of the HUF in which she was born, when she gets married. Thereafter, she becomes a member of the HUF of her husband. Some members of the HUF are called co-parceners. They are related to each other and to the head of the family. HUF may contain many members, but members within four degrees including the head of the family (kartha) are called co-parceners. A Hindu co-parcenary includes those persons who acquire by birth an interest in the joint coparcenary property. Only the coparceners have a right to partition. A Jain undivided family would also be assessed as a HUF, as Jains are also governed by the laws as Hindus.

(iii) *Company [Section 2(17)]:* For all purposes of the Act the term 'Company', has a much wider connotation than that under the Companies Act. Under the Act, the expression 'Company' means:

- any Indian company as defined in section 2(26); or
- anybody corporate incorporated by or under the laws of a country outside India, i.e., any foreign company; or
- any institution, association or body which is assessable or was assessed as a company for any assessment year under the Indian Income-tax Act, 1922 or for any assessment year commencing on or before 1.4.1970 under the present Act; or
- any institution, association or body, whether incorporated or not and whether Indian or non-Indian, which is declared by a general or special order of the CBDT to be a company for such assessment years as may be specified in the CBDT's order.

Did u know? **What are the types of companies?**

There are two types of Companies:

(1) Domestic Companies [Section 2(22A)] - means an Indian company or any other company which, in respect of its income liable to income-tax, has made the prescribed arrangements for the declaration and payment of dividends (including dividends on preference shares) within India, payable out of such income.

(2) Foreign Companies [Section 2(23A)] - Foreign company means a company which is not a domestic company.

(iv) *Firm:* The terms 'firm', 'partner' and 'partnership' have the same meanings as assigned to them in the Indian Partnership Act. In addition, the definitions also include the terms as they have been defined in the Limited Liability Partnership (LLP) Act, 2008.

However, for income-tax purposes a minor admitted to the benefits of an existing partnership would also be treated as partner. This is specified under section 2(23) of the Act. A partnership is the relation between persons who have agreed to share the profits of business carried on by all or any of them acting for all. The persons who have entered into partnership with one another are called individually 'partners' and collectively a 'firm'.

Notes

1. Consequent to the Limited Liability Partnership Act, 2008 coming into effect in 2009 and notification of the Limited Liability Partnership Rules w.e.f. 1st April, 2009, the Finance (No.2) Act, 2009 has incorporated the taxation scheme of LLPs in the Income-tax Act on the same lines as applicable for general partnerships, i.e. tax liability would be attracted in the hands of the LLP and tax exemption would be available to the partners. Therefore, the same tax treatment would be applicable for both general partnerships and LLPs.
2. Consequently, the following definitions in section 2(23) have been amended –
   (a) The definition of 'partner' to include within its meaning, a partner of a limited liability partnership;
   (b) The definition of 'firm' to include within its meaning, a limited liability partnership; and
   (c) The definition of 'partnership' to include within its meaning, a limited liability partnership.

(v) *Association of Persons (AOP):* When persons combine together for promotion of joint enterprise they are assessable as an AOP when they do not in law constitute a partnership. In order to constitute an association, persons must join in a common purpose, common action and their object must be to produce income; it is not enough that the persons receive the income jointly. Co-heirs, co-legatees or co-donees joining together for a common purpose or action would be chargeable as an AOP.

(vi) *Body of Individuals (BOI):* It denotes the status of persons like executors or trustees who merely receive the income jointly and who may be assessable in like manner and to the same extent as the beneficiaries individually. Thus co-executors or co-trustees are assessable as a BOI as their title and interest are indivisible. Income-tax shall not be payable by an assessee in respect of the receipt of share of income by him from BOI and on which the tax has already been paid by such BOI.

(vii) *Local Authority:* The term 'local authority' means a municipal committee, district board, and body of port commissioners or other authority legally entitled to or entrusted by the Government with the control or management of a municipal or local fund.

Notes A local authority is taxable in respect of that part of its income which arises from any business carried on by it in so far as that income does not arise from the supply of a commodity or service within its own jurisdictional area. However, income arising from the supply of water and electricity even outside the local authority's own jurisdictional areas is exempt from tax.

Notes

(viii) *Artificial Persons:* This category could cover every artificial juridical person not falling under other heads. An idol or deity would be assessable in the status of an artificial juridical person.

(3) ***Income [Section 2(24)]:*** Section 2(24) of the Act gives a statutory definition of income. This definition is inclusive and not exhaustive. Thus, it gives scope to include more items in the definition of income as circumstances may warrant. At present, the following items of re-ceipts are included in income:

- Profits and gains.
- Dividends.
- Voluntary contributions received by a trust/institution created wholly or partly for charitable or religious purposes or by an association or institution referred to in section 10(21) or section (23C)(iiiad)/(iiiae)/(iv)/(v)/(vi)/(via) or an electoral trust–

Research association approved under Section 35(1) (ii)	10 (21)
Universities and other educational institutions	10 (23C) (iii ad) and (vi)
Hospitals and other medical institutions	10 (23C) (iv)
Notified trust or institutions established wholly for public religious purposes or wholly established for public religious and charitable purposes	10 (23C) (v)
Electoral trust	13 B

Source: http://220.227.161.86/18878sm_dtl_finalnew_cp1.pdf

- The value of any perquisite or profit in lieu of salary taxable under section 17.
- Any special allowance or benefit other than the perquisite included above, specifically granted to the assessee to meet expenses wholly, necessarily and exclusively for the performance of the duties of an office or employment of profit.
- Any allowance granted to the assessee to meet his personal expenses at the place where the duties of his office or employment of profit are ordinarily performed by him or at a place where he ordinarily resides or to compensate him for the increased cost of living.
- The value of any benefit or perquisite whether convertible into money or not, obtained from a company either by a director or by a person who has a substantial interest in the company or by a relative of the director or such person and any sum paid by any such company in respect of any obligation which, but for such payment would have been payable by the director or other person aforesaid.
- The value of any benefit or perquisite, whether convertible into money or not, which is obtained by any representative assessee mentioned under section 160(1)(iii) and (iv), or by any beneficiary or any amount paid by the representative assessee for the benefit of the beneficiary which the beneficiary would have ordinarily been required to pay.
- Deemed profits chargeable to tax under section 41 or section 59.
- Profits and gains of business or profession chargeable to tax under section 28.
- Any capital gains chargeable under section 45.
- The profits and gains of any insurance business carried on by Mutual Insurance Company or by a cooperative society, computed in accordance with Section 44 or any surplus taken to be such profits and gains by virtue of the provisions contained in the first Schedule to the Act.

Notes

- The profits and gains of any business of banking (including providing credit facilities) carried on by a co-operative society with its members.
- Any winnings from lotteries, cross-word puzzles, races including horse races, card games and other games of any sort or from gambling, or betting of any form or nature whatsoever. For this purpose,
  - "Lottery" includes winnings, from prizes awarded to any person by draw of lots or by chance or in any other manner whatsoever, under any scheme or arrangement by whatever name called;
  - "Card game and other game of any sort" includes any game show, an entertainment programme on television or electronic mode; in which people compete to win prizes or any other similar game.
- Any sum received by the assessee from his employees as contributions to any provident fund (PF) or superannuation fund or Employees State Insurance Fund (ESI) or any other fund for the welfare of such employees.
- Any sum received under a Keyman insurance policy including the sum allocated by way of bonus on such policy will constitute income.

Did u know? "Keyman insurance policy" refers to a life insurance policy taken by a person on the life of another person where the latter is or was an employee or is or was connected in any manner whatsoever with the former's business.

- Any sum referred to clause (va) of Section 28. Thus, any sum, whether received or receivable in cash or kind, under an agreement for not carrying out any activity in relation to any business; or not sharing any know-how, patent, copy right, trade-mark, licence, franchise, or any other business or commercial right of a similar nature, or information or technique likely to assist in the manufacture or processing of goods or provision of services, shall be chargeable to income tax under the head "profits and gains of business or profession".
- Any sum of money or value of property referred to in section 56(2)(vii) or section 56(2)(viia).
- Any consideration received for issue of shares as exceeds the fair market value of shares referred to in section 56(2)(viib).

(4) ***Dividend [Section 2(22)]:*** The term 'dividend' as used in the Act has a wider scope and meaning than under the general law. According to section 2(22) of the Act, the following receipts are deemed to be dividend:

- *Distribution of accumulated profits, entailing the release of company's assets:* Any distribution of accumulated profits, whether capitalised or not, by a company to its shareholders is dividend if it entails the release of all or any part of its assets. For example, if accumulated profits are distributed in cash it is dividend in the hands of the shareholders. Where accumulated profits are distributed in kind, for example by delivery of shares etc. entailing the release of company's assets, the market value of such shares on the date of such distribution is deemed dividend in the hands of the shareholder [section 2(22)(a)].
- *Distribution of debentures, deposit certificates and bonus shares to preference shareholders:* Any distribution to its shareholders by a company of debenture stock or deposit certificate in any form, whether with or without interest, and any distribution of bonus shares to preference shareholders to the extent to which the company possesses

accumulated profits, whether capitalised or not, will be deemed as dividend. The market value of such bonus shares is taxable in the hands of the preference shareholder. In the case of debentures, debenture stock etc., their value is to be taken at the market rate and if there is no market rate they should be valued according to accepted principles of valuation [section 2(22)(b)].

Caution Bonus shares given to equity shareholders are not treated as dividend.

- *Distribution on liquidation:* Any distribution made to the shareholders of a company on its liquidation, to the extent to which the distribution is attributable to the accumulated profits of the company immediately before its liquidation, whether capitalised or not, is deemed to be dividend income [section 2(22)(c)]. Any distribution made out of the profits of the company after the date of the liquidation cannot amount to dividend. It is a repayment towards capital

  Accumulated profits include all profits of the company up to the date of liquidation whether capitalised or not. But where liquidation is consequent to the compulsory acquisition of an undertaking by the Government or by any corporation owned or controlled by the Government, the accumulated profits do not include any profits of the company prior to the three successive previous years immediately preceding the previous year in which such acquisition took place subject to certain exceptions.

Caution The dividend does not include a distribution made in accordance with sub-clause (c) in respect of any share issued for full cash consideration, where the holder of the share is not entitled in the event of liquidation to participate in the surplus assets.

- *Distribution on reduction of capital:* Any distribution to its shareholders by a company on the reduction of its capital to the extent to which the company possessed accumulated profits, whether capitalised or not, shall be deemed to be dividend [section 2(22)(d)].

- *Advance or loan by a closely held company to its shareholder:* Any payment by a company in which the public are not substantially interested of any sum by way of advance or loan to any shareholder who is the beneficial owner of 10% or more of the equity capital of the company will be deemed to be dividend to the extent of the accumulated profits. If the loan is not covered by the accumulated profits, it is not deemed to be dividend [section 2(22)(e)].

Notes There are two exceptions to this rule:

1. If the loan is granted in the ordinary course of its business and lending of money is a substantial part of the company's business, the loan or advance to a shareholder is not deemed to be dividend.

2. Where a loan had been treated as dividend and subsequently the company declares and distributes dividend to all its shareholders including the borrowing shareholder, and the dividend so paid is set off by the company against the previous borrowing, the adjusted amount will not again be treated as a dividend.

(5) ***India [Section 2(25A)]:*** The term 'India' means:

(a) the territory of India as per article 1 of the Constitution,

(b) its territorial waters, seabed and subsoil underlying such waters,

(c) continental shelf,

(d) exclusive economic zone or

(e) any other specified maritime zone and the air space above its territory and territorial waters.

Specified maritime zone means the maritime zone as referred to in the Territorial Waters, Continental Shelf, Exclusive Economic Zone and the Maritime Zones Act, 1976.

(6) ***Assessment Year:*** The term 'Assessment Year' has been defined under section 2(9). This means a period of 12 months commencing on 1st April every year. The year in which tax is paid is called the assessment year while the year in respect of the income of which the tax is levied is called the previous year. Income of previous year of an assessee is taxed during the next following assessment year at the rates prescribed by the relevant Finance Act.

Example: For the assessment year 2013–14, the relevant previous year is 2012–13 (1.4.2012 to 31.3.2013).

(7) ***Previous Year [Section 3]:*** It means the financial year immediately preceding the assessment year. The income earned during the previous year is taxed in the assessment year.

Business or profession newly set up during the financial year – In such a case, the previous year shall be the period beginning on the date of setting up of the business or profession and ending with 31st March of the said financial year. If a source of income comes into existence in the said financial year, then the previous year will commence from the date on which the source of income newly comes into existence and will end with 31st March of the financial year.

Example: For the assessment year 2011–12, the immediately preceding financial year (i.e., 2010–11) is the previous year. Income earned by an individual during the previous year 2010–11 is taxable in the immediately following assessment year 2011–12 at the rates applicable for the assessment year 2011–12. Similarly, income earned during the previous year 2011–12 by a company will be taxable in the assessment year 2012–13 at the rates applicable for the assessment year 2012–13.

Task A chartered accountant sets up his practice on 1st July, 2012. Determine the previous year for the assessment year 2013–14.

(8) ***Gross Total Income:*** 'Gross Total Income' may be defined as the aggregate of income computed in accordance with the provisions of this act before making any deduction under Chapter-VI A of Income Tax Act, 1961.

(9) ***Total Income:*** Any assessee has to pay income tax on different types of income derived on the basis of residential status. As per section 45 of Income Tax Act, 1961 'Total Income' means, Income shown in Section 5 of Income Tax Act, 1961:

- Salary Income
- Income from House property
- Income from Business and Profession
- Capital gains and
- Income from other sources.

These five are also called as 'Heads of Income'. The Income is determined under different sections. But some of the Incomes which are exempted are not included in Total Income.

Self Assessment

State whether the following statements are true or false:

16. 'Assessee' means a person by whom any tax or any other sources of money is payable under the Income Tax Act.
17. The definition of 'assessee' leads us to the definition of 'person'.
18. Under the Income-tax Act, a Hindu Undivided Family (HUF) is not treated as a separate entity for the purpose of assessment.
19. For all purposes of the Act the term 'Company', has a much wider connotation than that under the Companies Act.
20. AOP denotes the status of persons like executors or trustees who merely receive the income jointly and who may be assessable in like manner and to the same extent as the beneficiaries individually.

1.5 Income Tax Systems in India

The Indian Income Tax department is governed by the Central Board for Direct Taxes (CBDT) and is part of the Department of Revenue under the Ministry of Finance.

The government of India imposes an income tax on taxable income of individuals, Hindu Undivided Families (HUFs), companies, firms, co-operative societies and trusts (Identified as body of Individuals and Association of Persons) and any other artificial person. Levy of tax is separate on each of the persons. The levy is governed by the Indian Income Tax Act, 1961.

1. ***Charge to Income-tax:*** Income tax is a tax payable, at the rate enacted by the Union Budget (Finance Act) for every Assessment Year, on the Total Income earned in the Previous Year by every Person. The chargeability is based on the nature of income, i.e., whether it is revenue or capital.

   Section 4 of the Income-tax Act, 1961 is the charging section which provides that:

   (a) Tax shall be charged at the rates prescribed for the year by the annual Finance Act.

   (b) The charge is on every person specified under section 2(31).

   (c) Tax is chargeable on the total income earned during the previous year and not the assessment year. (There are certain exceptions provided by sections 172, 174, 174A, 175 and 176).

   (d) Tax shall be levied in accordance with and subject to the various provisions contained in the Act.

   This section is the back bone of the law of income-tax in so far as it serves as the most operative provision of the Act. The tax liability of a person springs from this section.

2. ***Rates of Tax:*** Income Tax Slab Rate for Year 2013–14(A.Y.) and Income Tax Rates for F.Y. 2013–14 (A.Y 2014–15) are same as budget of 2013 has made no changes in the Income tax slab rates for Individual, Woman, Senior Citizen, Super Senior Citizen and HUF/AOP/BOI/artificial juridical person and Companies. Income Tax Slab Rates 2012–13. Income Tax payer must be aware about the applicable Income Tax slab rate to him as it will help him to plan his income tax liability and also he can plan the Income Tax saving strategy in advance.

   Income Tax Slabs and Rates for AY 2014–15 (FY 2013–14) are as follows:

   (a) *For Individual or HUF or AOP or BOI or Artificial Judicial Person:*

Table 1.1: Tax Slabs for Individual, HUF and Artificial Judicial Person

	Income Slabs	Income Tax Rate
i.	Where the total income does not exceed ₹ 2, 00,000.	NIL
ii.	Where the total income exceeds ₹ 2,00,000 but does not exceed ₹ 5,00,000.	10% of amount by which the total income exceeds ₹ 2, 00,000. *Less:* Tax Credit - 10% of taxable income upto a maximum of ₹ 2000.
iii.	Where the total income exceeds ₹ 5,00,000 but does not exceed ₹ 10, 00,000.	₹ 30,000 + 20% of the amount by which the total income exceeds ₹ 5, 00,000.
iv.	Where the total income exceeds ₹ 10,00,000.	₹ 130,000 + 30% of the amount by which the total income exceeds ₹ 10,00,000

Source: http://finotax.com/itax/itaxrates13.htm

Surcharge: 10% of the Income Tax, where total taxable income is more than ₹ 1 crore.

Education Cess: 3% of the total of Income Tax and Surcharge.

   (b) *For Individual resident who is of the age of 60 years or more but below the age of 80 years at any time during the previous year*

Table 1.2: Tax Slabs for Individuals (Age of 60 years or more but below 80 years)

	Income Slabs	Income Tax Rate
i.	Where the total income does not exceed ₹ 2, 50,000.	NIL
ii.	Where the total income exceeds ₹ 2,50,000 but does not exceed ₹ 5,00,000	10% of the amount by which the total income exceeds ₹ 2, 50,000.
iii.	Where the total income exceeds ₹ 5,00,000 but does not exceed ₹ 10,00,000	₹ 25,000 + 20% of the amount by which the total income exceeds ₹ 5, 00,000.
iv.	Where the total income exceeds ₹ 10,00,000	₹ 125,000 + 30% of the amount by which the total income exceeds ₹ 10, 00,000.

Surcharge: 10% of the Income Tax, where total taxable income is more than ₹ 1 crore.

Education Cess: 3% of the total of Income Tax and Surcharge.

   (c) *Individual resident who is of the age of 80 years or more at any time during the previous year*

Table 1.3: Tax Slabs for Individual (Age 80 years or more)

	Income Slabs	Income Tax Rate
i.	Where the total income does not exceed ₹ 5, 00,000.	NIL

Contd...

ii.	Where the total income exceeds ₹ 5,00,000 but does not exceed ₹ 10,00,000	20% of the amount by which the total income exceeds ₹ 5, 00,000.
iii.	Where the total income exceeds ₹ 10,00,000	₹ 1,00,000 + 30% of the amount by which the total income exceeds ₹ 10, 00,000.

Surcharge: 10% of the Income Tax, where total taxable income is more than ₹ 1 crore.

Education Cess: 3% of the total of Income Tax and Surcharge.

(d) *For Co-operative Society*

Table 1.4: Tax Slabs for Co-operative Society

	Income Slabs	Income Tax Rate
i.	Where the total income does not exceed ₹ 10,000.	10% of the income.
ii.	Where the total income exceeds ₹ 10,000 but does not exceed ₹ 20,000.	₹ 1,000 + 20% of income in excess of ₹ 10,000.
iii.	Where the total income exceeds ₹ 20,000.	₹ 3,000 + 30% of the amount by which the total income exceeds ₹ 20,000.

Surcharge: 10% of the Income Tax, where total taxable income is more than ₹ 1 crore.

Education Cess: 3% of the total of Income Tax and Surcharge.

(e) *Firm:* The rate of Income-tax charged on firm is 30% of total income. Surcharge is paid at 10% of the Income Tax, where total taxable income is more than ₹ 1 crore. Education Cess @ 3% of the total of Income Tax and Surcharge will also be charged.

(f) *Local Authority:* For local authority the Income-tax rate is 30% of total income. Surcharge is 10% of the Income Tax, where total taxable income is more than ₹ 1 crore and Education Cess is 3% of the total of Income Tax and Surcharge.

(g) *Domestic Company:* Income-tax is 30% of total income. In respect to surcharge the amount of income tax as computed in accordance with above rates, and after being reduced by the amount of tax rebate shall be increased by a surcharge.

- ♦ At the rate of 5% of such income tax, provided that the total income exceeds ₹ 1 crore.
- ♦ At the rate of 10% of such income tax, provided that the total income exceeds ₹ 10 crore.

The Education Cess will be charged @ 3% of the total of Income Tax and Surcharge.

(h) *Company other than a Domestic Company:* The taxation rate surcharge and education cess levied on company other than domestic company can be stated as:

(i) Income-tax: It is chargeable @ 50% of on so much of the total income as consist of (a) royalties received from Government or an Indian concern in pursuance of an agreement made by it with the Government or the Indian concern after the 31st day of March, 1961 but before the 1st day of April, 1976; or (b) fees for rendering technical services received from Government or an Indian concern in pursuance of an agreement made by it with the Government or the Indian concern after the 29th day of February, 1964 but before the 1st day of April, 1976, and where such agreement has, in either case, been approved by the Central Government. @ 40% of the balance.

(ii) Surcharge: The amount of income tax as computed in accordance with above rates, and after being reduced by the amount of tax rebate shall be increased by a surcharge as under

- At the rate of 2% of such income tax, provided that the total income exceeds ₹ 1 crore.
- At the rate of 5% of such income tax, provided that the total income exceeds ₹ 10 crore.

(iii) Education Cess: 3% of the total of Income Tax and Surcharge.

Did u know? As per 2013 Budget (Finance Act, 2013) section 87A of the Income Tax Act, 1961 rebate of ₹ 2,000/- will be given to the individual tax payer whose total does not exceed ₹ 5 lakhs or we can say that Individual Tax Payer whose total income doesn't exceed ₹ 5 Lakhs is eligible for deduction of ₹ 20,000/- from income. Budget of 2013 has levied the Surcharge of 10 per cent on persons (other than companies) whose taxable income exceed ₹ 1 crore to augment revenues. Also government has increase the dividend distribution tax or tax on distributed income, current surcharge increased from 5 to 10 per cent.

Task Compute the tax liability of X Ltd., a domestic company, assuming that the total income of X Ltd. is ₹ 1,01,00,000 and the total income does not include any income in the nature of capital gain.

Self Assessment

Fill in the blanks:

21. ………………………….is governed by the Central Board for Direct Taxes (CBDT) and is part of the Department of Revenue under the Ministry of Finance.
22. The levy is governed by the ………………………….
23. Income tax is a tax payable, at the rate enacted by ……………………..for every Assessment Year.
24. The chargeability is based on the ……………………..

Case Study

Vodafone Tax Case – Investments in India

India Inc. has been surging ahead audaciously with the support of its Information Technology developments with its repertoire of resources. Global players have been eying the Indian market, owing to immense opportunities that the continent provides; both in terms of expansion and profit. Investment patterns in India have shown positive growth over the years with significant process on the de-regulation front. India has been greatly involved with the G-8 and G-20, including signing of the Double Taxations Avoidance Agreements/Treaties (DTAA) with various tax-haven countries. This has boosted the image of India as a 'lookout destination' for investment and an emerging hub for economical activities. World Report 2010 ranked India as the 9th most attractive

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investment destination, while Bloomberg Global Poll conducted in September 2010 put India in the third position, above the United States of America (US).

However, the very same image is said to have taken a beating with the recent Vodafone Tax case, which has been revolving in courts since 2009. With clear signs of the court ruling in favour of the tax authorities, many global companies are said to be rethinking their investment plans in India, keeping in mind the impact of the judgment on the taxation front. The Doing Business Report 2011 of World Bank has ranked India at 134, below neighbouring countries like Pakistan and Bhutan. This is a result of procedural difficulties for start-up companies and investment companies, in India and abroad.

Tax regulations play a major role in cross border transactions and investments in a country. Tax havens, open borders and DTAA countries are major destinations for investment through Foreign Direct Investment (FDI) or other routes. The Vodafone tax case throws an interesting question on the taxability of a non-resident company acquiring shares of a resident company through an indirect route. This is a landmark case, as it is for the first time that the tax departments have sought to tax a company through a mechanism of tracing the source of acquisition. While we have heard about lifting the 'corporate veil', this instance has set a rare example wherein the Indian tax authorities have gone to length to interpret the existing tax laws, to bring a global company like Vodafone to its tax ambit.

Vodafone International Holdings BV, based in Netherlands and controlled by Vodafone UK, obtained the controlling interest and share of CGP Investments Holdings Ltd (CGP) located in Cayman Island for a value of $11.01 billion from Hutchinson Telecommunications International Ltd (HTIL), which had stake in Hutchinson Essar Ltd (HEL) that handled the company's mobile operations in India. HEL had its stake in CGP Holdings, from which Vodafone bought 52 per cent of HEL's stake in 2007, thereby vesting controlling interest over them. The Bombay High Court, on September 8, ruled that where the underlying assets of the transaction between two or more offshore entities lies in India, it is subject to capital gains tax under relevant income tax laws in India. The Court invoked the nexus rule wherein a state can tax by connecting a person sought to be taxed with the jurisdiction, which seeks to tax. The treatment of the company as an Assessee in Default (AID) under Section 201(1)of the Income Tax Act and reading Sections 5(2), 9(1) and 195, the court came to the conclusion that Vodafone was liable to deduct tax at source (TDS). Vodafone has now appealed before the Supreme Court to revisit the judgment, which makes them liable for a record amount of ₹ 12,000 crore going to the tax authorities' kitty.

Vodafone raises pertinent questions on the issue of taxation of non-resident entities. The judgment will have direct impact on transactions of major acquisitions like SABMiller-Foster and Sanofi Aventis-Shanta Biotech. Similar transactions that existed earlier are Sesa Goa, AT&T and General Electric. British firm Cairn Energy has already agreed to pay tax in India as well as the UK on selling its stake in Cairn India to Vedanta Resources from $6.65 billion to $8.48 billion. Depending upon the size of the stake sale, the tax liability could range between $868 million and $1.1 billion. The judgment would definitely throw a cautious note to major investors and M&As in India; however, it does not have that great an impact to curtail the investment flow to an emerging destination like India. The judicial propriety of the case is still to be settled when the matter comes for final stages in the Supreme Court. Going by the events in the lower courts, the Supreme Court is unlikely to disturb the Bombay High Court ruling.

The global community is keenly watching the current trends happening in the Indian subcontinent, especially since it has become an emerging player at the socio-economic and political levels. United Nations Conference on Trade and Development (UNCTAD) has reported that India is set to dislodge the US by December 2012 to become the second best destination for FDIs, the major component of which is M&As. India is also set to

Contd...

Notes

revamp its taxations norms with significant changes at the regulatory level. The proposed Direct Tax Code contains key provisions, which will have a major impact on investments in India. India has improved its rankings in the WB 'Doing Business' Report on the number of regulatory changes taken in the existing year. This shows that the country is set to make a global footprint by branding itself as a 'Must Invest' destination.

The Vodafone tax case has given India the opportunity to create a model for other countries, which follow source-based taxation principles. It is an opportune time to bask in the glory of India, which is said to have had one third share of the world market in ancient times, as pointed out by economist Amartya Sen in his book 'The Argumentative Indian'.

Questions

1. Study and analyse the case.
2. Write down the case facts.
3. What do you infer from it?

Source: http://www.mindtext.org/view/89/Vodafone_Tax_case_A_Case_Study_for_Investments_in_India/

1.6 Summary

- Every country generates income from 'Income-Tax' in the form of direct tax levied by government. Income-tax plays a vital role in the economy of every country in the world. Income-tax act was enacted in the year 1961.
- Income, in general, means a periodic monetary return which accrues or is expected to accrue regularly from definite sources.
- The "tax net" refers to the types of payment that are taxed, which included personal earnings (wages), capital gains, and business income. The rates for different types of income may vary and some may not be taxed at all.
- Tax rates may be progressive, regressive, or flat. A progressive tax taxes differentially based on how much has been earned.
- A tax system may use different taxation methods for different types of income.
- The Indian Income Tax department is governed by the Central Board for Direct Taxes (CBDT) and is part of the Department of Revenue under the Ministry of Finance.
- The government of India imposes an income tax on taxable income of individuals, Hindu Undivided Families (HUFs), companies, firms, co-operative societies and trusts (Identified as body of Individuals and Association of Persons) and any other artificial person. Levy of tax is separate on each of the persons.
- Income-tax is to be charged at the rates fixed for the year by the annual Finance Act.
- Income from agricultural sources will be included in 'total income', to determine tax-liability.
- The levy is governed by the Indian Income Tax Act, 1961.

1.7 Keywords

Assessee: He/she is a person by whom any tax or any other sources of money is payable.

Body of Individuals (BOI): It denotes the status of persons like executors or trustees who merely receive the income jointly and who may be assessable in like manner and to the same extent as the beneficiaries individually.

Company: A voluntary association formed and organized to carry on a business.

Direct Tax: A tax that is paid directly by an individual or organization to the imposing entity.

Dividend: Dividends are payments made by a corporation to its shareholder members. It is the portion of corporate profits paid out to stockholders.

Flat Tax: A flat tax (short for flat tax rate) is a tax system with a constant marginal rate, usually applied to individual or corporate income.

Gross Total Income: It is an individual's total personal income before taking taxes or deductions into account.

Income Tax: An income tax is a tax levied on the income of individuals or businesses (corporations or other legal entities).

Income: Income is the consumption and savings opportunity gained by an entity within a specified timeframe that is generally expressed in monetary terms.

Indirect Tax: Indirect taxes are those paid by consumers when they buy goods and services.

Progressive Tax: A progressive tax is a tax in which the tax rate increases as the taxable base amount increases.

Regressive Tax: A regressive tax is a tax imposed in such a manner that the tax rate decreases as the amount subject to taxation increases.

Surcharge: A surcharge is an extra charge added to the price of something, or a standalone charge that exists for using something.

Tax Net: It refers to the types of payment that are taxed, which included personal earnings (wages), capital gains, and business income.

1.8 Review Questions

1. Discuss the historical background of Income-tax. What is its importance?
2. What is net tax?
3. What are the components of Income Tax Law?
4. 'Every assessee is a person, but every person need not be an assessee'. Critically examine the statement with reference to the relevant definitions under the provisions of the Income Tax Act, 1951.
5. "Income tax is a tax on income and not a tax on every item of money received." Explain this statement with reference to capital and revenue receipts.
6. Write brief notes on the following:
   (a) Assessment Year
   (b) Income
   (c) Gross Total Income
   (d) Previous Year
   (e) Assesse
7. "Every financial year is an assessment year". Comment.
8. "Income of a previous year is chargeable tax in the immediately following assessment year". Discuss.

Notes

9. X starts his business on April 26, 2010. Determine the previous year to the assessment year 2011–12.
10. Mr. Sharma has a total income of ₹ 20,10,000. Compute his gross tax liability.
11. Discuss the Income Tax System in India.

Answers: Self Assessment

1.	Direct taxes	2.	Indirect
3.	Government	4.	Financial bill
5.	CBDT	6.	False
7.	True	8.	True
9.	False	10.	True
11.	Capital gains	12.	Capital receipts
13.	Revenue receipts	14.	Annuities
15.	Subsidies and grants	16.	True
17.	True	18.	False
19.	True	20.	False
21.	Indian Income Tax department	22.	Indian Income Tax Act, 1961
23.	Union budget	24.	Nature of Income

1.9 Further Readings

Books

Aggarwal, K. *Direct Tax Planning and Management.* Atlantic Publications.

Ahuja, G. K. and Gupta, Ravi. *Systematic Approach to Income Tax.* Bharat Law House.

Lakhotia, R. N. *Income Tax Planning Handbook.* Vision Books.

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Srinivas E. A. *Handbook of Corporate Tax Planning.* Tata McGraw Hill.

Online links

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http://www.choleraassociates.com/pdf/income_tax_brochure.pdf

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http://www.ekikrat.in/Basics-Income-Tax-India

http://www.incometaxmanagement.com/Pages/Taxation-System/Capital-&-Revenue.html

http://www.tax4india.com/

Unit 2: Residential Status and Taxation

CONTENTS

Objectives

After studying this unit, you will be able to:

- Define the meaning and scope of residential status of an individual
- Discuss the provisions of analysing the residential status of an individual
- Describe the residential status of a company and other legal entities existing in India
- Explain incidence of tax and its importance
- Elucidate the concept of deemed receipt and accrual of income in India
- Trace the categories of income which are deemed to accrue or arise in India

Introduction

Tax incidence on an assessee depends on his residential status. For instance, whether an income, accrued to an individual outside India, is taxable in India depends upon the residential status of the individual in India. Likewise, whether an income earned by a foreign national in India or outside India taxable in India depends on the residential status of the individual, rather than on his citizenship. Therefore, the determination of the residential status of a person is very significant in order to find out his tax liability.

The inclusion of a particular income in the Total Income of a person for income-tax in India is based on his residential status. There are three residential statuses that we will study in detail this unit namely the Residents also referred to as Resident & Ordinarily Residents, the Resident but not Ordinarily Residents and the Non-residents. There are several steps involved in determining the residential status of person. All residents are taxable for all their income, including income outside India. Non-residents are taxable only for the income received in India or Income accrued in India. Not Ordinarily Residents are taxable in relation to income received in India or income accrued in India and income from business or profession controlled from India.

2.1 Residential Status (Section 6)

The incidence of tax on any assessee depends upon his residential status under the Act. Therefore, after determining whether a particular amount is capital or revenue in nature, if the receipt is of a revenue nature and chargeable to tax, it has to be seen whether the assessee is liable to tax in respect of that income. The taxability of a particular receipt would thus depend upon not only the nature of the income and the place of its accrual or receipt but also upon the assessee's residential status.

The following norms one has to keep in mind while deciding the residential status of an assessee:

1. ***Different taxable entities:*** All taxable entities are divided in the following categories for the purpose of determining residential status:

   a. An individual;

   b. A Hindu undivided family;

   c. A firm or an association of persons;

   d. A joint stock company; and

   e. Every other person.

2. ***Different residential status:*** An assessee is either: (a) resident in India, or (b) non-resident in India.

   However, a resident individual or a Hindu undivided family has to be (a) resident and ordinarily resident, or (b) resident but not ordinarily resident.

   All other assessee who includes a firm, an association of persons, a joint stock company and every other person) can either be:

   a. Resident in India; or

   b. Non-resident in India.

3. ***Residential status for each previous year:*** Residential status of an assessee is to be determined in respect of each previous year as it may vary from previous year to previous year.

4. ***Different residential status for different assessment years:*** An assessee may enjoy different residential status for different assessment years. For instance, an individual who has been regularly assessed as resident and ordinarily resident has to be treated as non-resident in a particular assessment year if he satisfies none of the conditions of section 6(1).

5. ***Resident in India and abroad:*** It is not necessary that a person, who is "resident" in India, cannot become "resident" in any other country for the same assessment year. A person may be resident in two (or more) countries at the same time. It is, therefore, not necessary that a person who is resident in India will be non-resident in all other countries for the same assessment year.

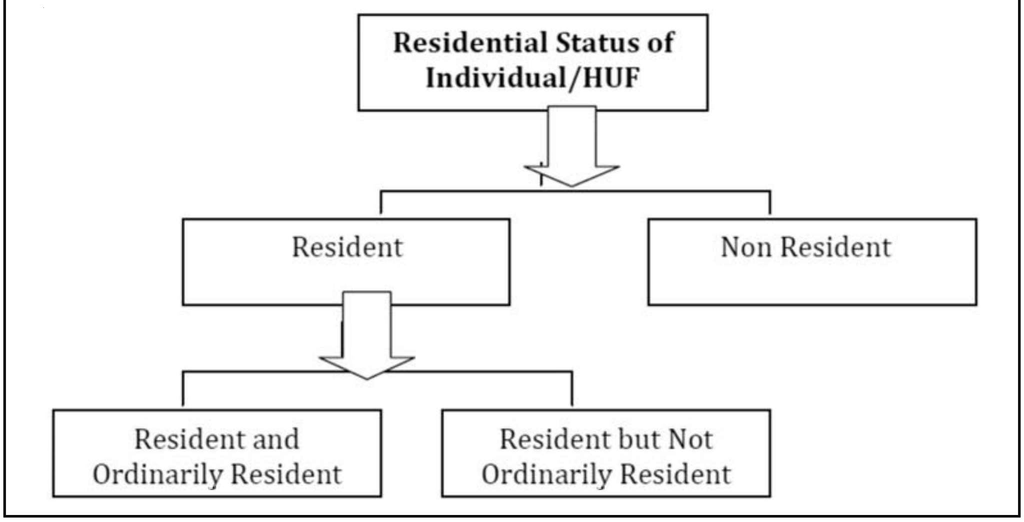
Therefore you can say that for all purposes of income-tax, taxpayers are classified into three broad categories on the basis of their residential status as stated below and as reflected in Figure 2.1:

(1) Resident and ordinarily resident

(2) Resident but not ordinarily resident

(3) Non-resident

Figure 2.1: Residential Status of Individual



Source: http://www.mu.ac.in/myweb_test/TYBCOM%20study%20material/T.Y.B.Com.Paper%20-%20V%20-%20Sec.I%20-%20Direct%20Taxes.pdf

The residential status of an assessee must be ascertained with reference to each previous year. A person who is resident and ordinarily resident in one year may become non-resident or resident but not ordinarily resident in another year or *vice versa.* The provisions for determining the residential status of assessee are:

1. ***Residential status of individuals:*** Under section 6(1), an individual is said to be resident in India in any previous year, if he satisfies any one of the following conditions:

   (i) He has been in India during the previous year for a total period of 182 days or more, or

   (ii) He has been in India during the 4 years immediately preceding the previous year for a total period of 365 days or more and has been in India for at least 60 days in the previous year.

   If the individual satisfies any one of the conditions mentioned above, he is a resident. If both the above conditions are not satisfied, the individual is a non-resident also referred to as NRI.

Example: X left India for the first time on May 20, 2003. During the financial year 2005–06, he came to India once on May 27 for a period of 53 days. Determine his residential status for the assessment year 2006–07. Since X comes to India only for 53 days in the previous year 2005–06, he does not satisfy any of the basic conditions laid down in section 6(1). He is, therefore, non-resident in India for the assessment year 2006–07.

Notes

a. The term "stay in India" includes stay in the territorial waters of India (i.e. 12 nautical miles into the sea from the Indian coastline). Even the stay in a ship or boat moored in the territorial waters of India would be sufficient to make the individual resident in India.

b. It is not necessary that the period of stay must be continuous or active nor is it essential that the stay should be at the usual place of residence, business or employment of the individual.

c. For the purpose of counting the number of days stayed in India, both the date of departure as well as the date of arrival are considered to be in India.

d. The residence of an individual for income-tax purpose has nothing to do with citizenship, place of birth or domicile. An individual can, therefore, be resident in more countries than one even though he can have only one domicile.

Exceptions:

The following categories of individuals will be treated as residents only if the period of their stay during the relevant previous year amounts to 182 days. In other words even if such persons were in India for 365 days during the 4 preceding years and 60 days in the relevant previous year, they will not be treated as resident.

1. Indian citizens, who leave India in any previous year as a member of the crew of an Indian ship or for purposes of employment outside India, or

2. Indian citizen or person of Indian origin engaged outside India in an employment or a business or profession or in any other vocation, who comes on a visit to India in any previous year

Caution A person is said to be of Indian origin if he or either of his parents or either of his grandparents were born in undivided India.

Not-ordinarily resident: Only individuals and HUF can be resident but not ordinarily resident in India. All other classes of assesses can be either a resident or non-resident. A not-ordinarily resident person is one who satisfies any one of the conditions specified under section 6(6).

(i) If such individual has been non-resident in India in any 9 out of the 10 previous years preceding the relevant previous year, or

(ii) If such individual has during the 7 previous years preceding the relevant previous year been in India for a period of 729 days or less.

Therefore in simpler terms, an individual is said to be a resident and ordinarily resident if he satisfies both the following conditions:

(i) He is a resident in any 2 out of the last 10 years preceding the relevant previous year, and

(ii) His total stay in India in the last 7 years preceding the relevant previous year is 730 days or more.

If the individual satisfies both the conditions mentioned above, he is a resident and ordinarily resident but if only one or none of the conditions are satisfied, the individual is a resident but not ordinarily resident.

Example: Steve Waugh, the Australian cricketer comes to India for 100 days every year. Find out his residential status for the A.Y. 2013–14.

Solution: For the purpose of his residential status in India for A.Y. 2013–14, the relevant previous year is 2012–13.

Step 1: The total stay of Steve Waugh in the last 4 years preceding the previous year is 400 days (i.e.100 × 4) and his stay in the previous year is 100 days. Therefore, since he has satisfied the second condition in section 6(1), he is a resident.

Step 2: Since his total stay in India in the last 7 years preceding the previous year is 700 days (i.e. 100 × 7), he does not satisfy the minimum requirement of 730 days in 7 years. Any one of the conditions not being satisfied, the individual is resident but not ordinarily resident.

Therefore, the residential status of Steve Waugh for the assessment year 2013–14 is resident but not ordinarily resident.

Example: Mr. B, a Canadian citizen, comes to India for the first time during the P. Y. 2008–09. During the financial years 2008–09, 2009–10, 2010–11, 2011–12 and 2012–13 he was in India for 55 days, 60 days, 90 days, 150 days and 70 days respectively. Determine his residential status for the A.Y.2013–14.

Solution: During the previous year 2012–13, Mr. B was in India for 70 days and during the 4 years preceding the previous year 2012–13, he was in India for 355 days (i.e. 55+ 60+ 90+ 150 days). Thus, he does not satisfy section 6(1). Therefore, he is a non-resident for the previous year 2012–13.

Example: Mr. C, a Japanese citizen left India after a stay of 10 years on 1.06.2010. During the financial year 2011–12, he comes to India for 46 days. Later, he returns to India for 1 year on 10.10.2012. Determine his residential status for the A. Y. 2013–14.

Solution: During the previous year 2012–13, Mr. C was in India for 173 days (i.e. 22 + 30 + 31+ 31+ 28 + 31 days). His stay in the last 4 years is:

2011–12 -	46	
2010–11 -	62	(i.e. 30 + 31 + 1)
2009–10 -	365	(since he left India on 1.6.2010 after 10 years)
2008–09 -	365	(since he left India on 1.6.2010 after 10 years)

The total number of days comes as 838. Thus Mr. C is a resident since his stay in the previous year 2012–13 is 173 days and in the last 4 years is more than 365 days. For the purpose of being ordinarily resident, it is evident from the above calculations, that his stay in the last 7 years is more than 730 days and since he was in India for 10 years prior to 1.6.2010, he was a resident in at least 2 out of the last 10 years preceding the relevant previous year.

Therefore, Mr. C is a resident and ordinarily resident for the A.Y. 2013–14.

Example: Mr. D, an Indian citizen, leaves India on 22.9.2012 for the first time, to work as an officer of a company in France. Determine his residential status for the A.Y. 2013–14.

Solution: During the previous year 2012–13, Mr. D, an Indian citizen, was in India for 175 days (i.e. 30+ 31+30+31+31+22 days). He does not satisfy the minimum criteria of 182 days. Also, since he is an Indian citizen leaving India for the purposes of employment, the second condition under section 6(1) is not applicable to him.

Therefore, Mr. D is a non-resident for the A.Y.2013–14.

2. ***Residential status of HUF:*** A HUF would be resident in India if the control and management of its affairs is situated wholly or partly in India.

   If the control and management of the affairs is situated wholly outside India it would become a non-resident. The expression 'control and management' referred to under section 6 refers to the central control and management and not to the carrying on of day-to-day business by servants, employees or agents. The business may be done from outside India and yet its control and management may be wholly within India. Therefore, control and management of a business is said to be situated at a place where the head and brain of the adventure is situated. The place of control may be different from the usual place of running the business and sometimes even the registered office of the assessee. This is because the control and management of a business need not necessarily be done from the place of business or from the registered office of the assessee. But control and management do imply the functioning of the controlling and directing power at a particular place with some degree of permanence.

   If the HUF is resident, then the status of the Karta determines whether it is resident and ordinarily resident or resident but not ordinarily resident. If the karta is resident and ordinarily resident, then the HUF is resident and ordinarily resident and if the karta is resident but not ordinarily resident, then HUF is resident but not ordinarily resident.

Example: The business of a HUF is transacted from Australia and all the policy decisions are taken there. Mr. E, the karta of the HUF, who was born in Kolkata, visits India during the P.Y. 2012–13 after 15 years. He comes to India on 1.4.2012 and leaves for Australia on 1.12.2012. Determine the residential status of Mr. E and the HUF for A.Y. 2013–14.

Solution: During the P.Y.2012–13, Mr. E has stayed in India for 245 days (i.e. 30+31+30+31+31+ 30+31+30+1 days). Therefore, he is a resident. However, since he has come to India after 15 years, he cannot satisfy any of the conditions for being ordinarily resident.

Therefore, the residential status of Mr. E for the P.Y.2012–13 is resident but not ordinarily resident. Since the business of the HUF is transacted from Australia and nothing is mentioned regarding its control and management, it is assumed that the control and management is also wholly outside India. Therefore, the HUF is a non-resident for the P.Y. 2012–13.

3. ***Residential status of firms and association of persons:*** A firm and an AOP would be resident in India if the control and management of its affairs is situated wholly or partly in India. Where the control and management of the affairs is situated wholly outside India, the firm would become a non-resident.

4. ***Residential status of companies:*** A company is said to be resident in India if:

   (i) It is an Indian company as defined under section 2(26), or

   (ii) Its control and management is situated wholly in India during the accounting year.

   Thus, every Indian company is resident in India irrespective of the fact whether the control and management of its affairs is exercised from India or outside. But a company, other than an Indian company, would become resident in India only if the entire control and management of its affairs is in India.

The control and management of the affairs of company are said to be exercised from the place where the director's meetings (not shareholders' meetings) are held, decisions taken and directions issued.

5. ***Residential status of local authorities and artificial juridical persons:*** Local authorities and artificial juridical persons would be resident in India if the control and management of its affairs is situated wholly or partly in India. Where the control and management of the affairs is situated wholly outside India, they would become non-residents.

Tasks

1. X, a foreign citizen comes to India, for the first time in the last 30 years on March 20, 2005. On September 1, 2005, he leaves India for Nepal on a business trip. He comes back on February 26, 2006. Determine the residential status of X for the assessment year 2006–07.
2. X, an Italian citizen, comes to India for the first time (after 20 years) on May 28, 2005. Determine his residential status for the assessment year 2006–07.

Self Assessment

Choose from the following the most appropriate answer:

1. 'R', a person of Indian origin visited India on 3.10.2010 and plans to stay here for 185 days. During 4 years prior to previous year 2011–12, he was in India for 750 days. Earlier to that he was never in India. For the AY 2012–13, 'R' shall be:
   a. resident and ordinarily resident in India
   b. resident but not ordinarily resident in India
   c. non-resident
2. 'X', a citizen of India left India for U.S. on 16.8.2010 for booking orders on behalf of an Indian Company for exporting goods to U.S. He came back to India on 5.5.2012. He had been resident in India for the past 10 years. For assessment year 2012–13, X shall be:
   a. resident and ordinarily resident in India
   b. resident but not ordinarily resident in India
   c. non-resident in India
3. 'Z', a citizen of India is employed on an Indian Ship. During the previous year 2011–12 he leaves India for Germany on 15.09.2011 for holidays and returned on 1.4.2012. He had been non-resident for the past 3 years. Earlier to that he was permanently in India. For assessment year 2012–13, Z shall be:
   a. resident and ordinarily resident in India
   b. resident but not ordinarily resident in India
   c. non-resident in India
4. 'S', a foreign national but a person of Indian origin visited India during the previous year 2011–12 for 181 days. During 4 preceding previous years he was in India for 400 days, 'S' shall be:
   a. resident in India

b. non-resident in India

c. not ordinarily resident in India

2.2 Residential Status of a Company

An Indian company is always resident in India. A foreign company is resident in India only if during the previous year, control and management of its affairs is situated wholly in India. Conversely, a foreign company is treated as non-resident if during the previous year, control and management of its affairs is either is wholly or partly situated out of India.

Example: 'XYZ' Ltd., is an Indian Company, the entire control and management of its affairs is situated outside India. 'XYZ' Ltd., shall be considered as a resident in India.

> *Notes* If control and Management of a firm or association of firm is situated wholly or partially in India, it will be considered as Resident. Otherwise it will be considered as Non-resident.

A company can never be ordinarily or not ordinarily resident in India. In case of a foreign company even the slightest control and management is exercised from outside India, it would be treated as a non-resident.

The term "control and management" refers to the "head and the brain" which directs the affairs of policy, finance, disposal of profits and vital things concerning the management of the company. Usually the control and management of a company's affairs is situated at the place where meetings of its board of directors are held. In case of a subsidiary company managed by its local board of directors, it is difficult to establish that control and management of its affairs vests at the place where the parent company resides.

Did u know? A foreign company means a company incorporated outside India but having a place of business in India.

Self Assessment

State whether the following statements are true or false:

5. An Indian Company is always resident in India.
6. A foreign company is always non-resident in India.
7. A foreign company means a company incorporated outside India but having a place of business in India.
8. Control and management refers to the head and the brain which directs the affairs of policy, finance, disposal of profits and vital things concerning the management of the company.
9. In case of a subsidiary company managed by its local board of directors, it is easy to establish that control and management of its affairs vests at the place where the parent company resides.

2.3 Incidence of Tax

The study of incidence is very important. The tax system is not merely aimed at raising a certain amount of revenue, but the aim is to raise it from those sections of the people who can best bear the tax. The aim, in short, is to secure a just distribution of the tax burden. This obviously cannot be done unless an effort is made to trace the incidence of each tax levied by the State. We must know who pays it ultimately in order to find out whether it is just to ask him to pay it, or whether the burden imposed on him is according to the ability of the tax-payer or not. If the tax system is to conform to Adam Smith's first canon of taxation, viz., the canon of equality, it becomes imperative to make a careful study of the reactions and repercussions of each tax and find out its final resting place.

There are certain taxes, called direct taxes, which are borne by the people who pay them first. The incidence in such cases is apparent. But the tax system of a country is not merely composed of direct taxes. There are indirect taxes also whose reactions are a complicated affair. These taxes are intended to be shifted. Hut in actual practice, on account of economic friction, the shifting may not take place at all or it may be partial, or the tax may be shifted on to a class of people quite different from those intended to bear it.

If Public Finance is to serve as an instrument of social justice, the question of incidence at once assumes great importance. The rich have to be taxed and the proceeds have to be spent for the benefit of the poor. If you have to tax the rich, the incidence must be on the rich; otherwise the object is not served. We must, therefore, follow each tax and make sure that it finds a rich home to rest in.

Did u know? The incidence of income tax paid by a person will be on him. Import duty is an indirect tax and can, therefore, be shifted. Income-tax, on the other hand, is a direct tax and it cannot be shifted.

As per section 5, incidence of tax on a taxpayer depends on his residential status and also on the place and time of accrual or receipt of income. In order to understand the relationship between residential status and tax liability, one must understand the meaning of "Indian income" and "foreign income".

1. ***Indian income:*** Any of the following three is an Indian income

   (i) If income is received (or deemed to be received) in India during the previous year and at the same time it accrues (or arises or is deemed to accrue or arise) in India during the previous year.

   (ii) If income is received (or deemed to be received) in India during the previous year but it accrues (or arises) outside India during the previous year.

   (iii) If income is received outside India during the previous year but it accrues (or arises or is deemed to accrue or arise) in India during the previous year.

2. ***Foreign income***: If the following two conditions are satisfied, then such income is "foreign income":

   (i) Income is not received (or not deemed to be received) in India; and

   (ii) Income does not accrue or arise (or does not deemed to accrue or arise) in India.

Notes

The above provisions may be explained in brief as follows:

Whether income is received (or deemed to be received) in India during the relevant year	Whether income accrues (or arises or is deemed to accrue or arise) in India during the relevant year	Status of the income
Yes	Yes	Indian income
Yes	No	Indian income
No	Yes	Indian income
No	No	Foreign income

Notes Indian income – Indian income is always taxable in India irrespective of the residential status of the taxpayer.

Foreign income – Foreign income is taxable in the hands of resident or resident and ordinarily resident in India. It is not taxable in the hands of non-resident in India.

Following table shows the overall scope of income and its income tax chargeability in case of Resident and Non-resident:

Income	Resident and Ordinary Resident	Resident and Not ordinary Resident	Non-Resident
1. Income received or deemed to be received in India whether earned in India or elsewhere	Taxable	Taxable	Taxable
2. Income which accrues or arise or deemed to accrue or arise in India during the previous year, whether received in India or elsewhere.	Taxable	Taxable	Taxable
3. Income which accrues or arises outside India and received outside India from a business controlled from India	Taxable	Taxable	Not Taxable
4. Income which accrues or arises outside India and received outside India in the previous year from any other source	Taxable	Not Taxable	Not Taxable
5. Income which accrues or arises outside India and received outside India during the years preceding the previous year and remitted to India during the previous year.	Not Taxable	Not Taxable	Not Taxable

For any other taxpayer like company, firm, co-operative society, association of persons, body of individual, etc. the incidence of tax would include:

Types of Income	Resident in India	Non-resident in India
Indian income	Taxable in India	Taxable in India
Foreign income	Taxable in India	Not taxable in India

Example: The following details are known about the total income of Ms. Mamta

Dividend received from Indian Company ₹ 1,00,000

Dividend from foreign company ₹ 1,50,000

Income from business in Kenya but controlled from India ₹ 2,00,000

Income from business in Switzerland controlled from Bangladesh ₹ 5,00,000

Income accrued in Indonesia ₹ 2,00,000, 2/5th received in India.

Solution:

S. No.	Particulars	ROR	NOR	NRI
1	Dividend received from Indian Company	-	-	-
2	Dividend from foreign company	1,50,000	1,50,000	1,50,000
3	Income from business in Kenya but controlled from India	2,00,000	2,00,000	NIL
4	Income from business in Switzerland controlled from Bangladesh	5,00,000	-	-
5	Income accrued in Indonesia, 2/5th received in India	2,50,000	1,00,000	1,00,000
	Total Taxable Income	**11,00,000**	**4,50,000**	**2,50,000**

Self Assessment

State which of the following are taxable or non-taxable in hands of a Non-resident of India:

10. Income received or deemed to be received in India whether earned in India or elsewhere.
11. Income which accrues or arise or deemed to accrue or arise in India during the previous year, whether received in India or elsewhere.
12. Income which accrues or arises outside India and received outside India in the previous year from any other source.
13. Income which accrues or arises outside India and received outside India during the years preceding the previous year and remitted to India during the previous year.

2.4 Scope of Total Income

Section 5 provides the scope of total income in terms of the residential status of the assessee because the incidence of tax on any person depends upon his residential status. The scope of total income of an assessee depends upon the following three important considerations:

(i) The residential status of the assessee

(ii) The place of accrual or receipt of income, whether actual or deemed and

(iii) The point of time at which the income had accrued to or was received by or on behalf of the assessee.

Notes

The ambit of total income of the three classes of assesses would be as follows:

1. ***Resident and ordinarily resident:*** The total income of a resident assessee would, under section 5(1), consist of:

   (i) Income received or deemed to be received in India during the previous year;

   (ii) Income which accrues or arises or is deemed to accrue or arise in India during the previous year; and

   (iii) Income which accrues or arises outside India even if it is not received or brought into India during the previous year.

   In simpler terms, a resident and ordinarily resident has to pay tax on the total income accrued or deemed to accrue, received or deemed to be received in or outside India.

2. ***Resident but not ordinarily resident:*** Under section 5(1), the computation of total income of resident but not ordinarily resident is the same as in the case of resident and ordinarily resident stated above except for the fact that the income accruing or arising to him outside India is not to be included in his total income. However, where such income is derived from a business controlled from or profession set up in India, then it must be included in his total income even though it accrues or arises outside India.

3. ***Non-resident:*** A non-resident's total income under section 5(2) includes:

   (i) Income received or deemed to be received in India in the previous year; and

   (ii) Income which accrues or arises or is deemed to accrue or arise in India during the previous year.

Notes All assesses, whether resident or not, are chargeable to tax in respect of their income accrued, arisen, received or deemed to accrue, arise or to be received in India whereas residents alone are chargeable to tax in respect of income which accrues or arises outside India.

1. Resident and Ordinarily Resident: Income received/deemed to be received/ accrued or arisen/deemed to accrue or arises in or outside India.

2. Resident but Not Ordinarily Resident: Income which is received or deemed to be received/accrued or arisen/deemed to accrue or arise in India. And Income which accrues or arises outside India being derived from a business controlled from or profession set up in India.

3. Non-Resident: Income received/deemed to be received/accrued or arisen/deemed to accrue or arise in India.

Self Assessment

Fill in the blanks:

14. …………………..provides the scope of total income in terms of the residential status of the assessee.

15. The scope of total income of an assessee depends upon the ………… of the assessee.

16. Total income of a resident assessee would, under section 5(1) consist of Income received or deemed to be received in ……………during the previous year.

17. ……………………. has to pay tax on the total income accrued or deemed to accrue, received or deemed to be received in or outside India.

2.5 Deemed Receipt and Accrual of Income in India

The taxability of a certain item as income would also depend upon the method of accounting followed by the assessee. This is because under the cash system of accounting an income would be taxable only when it is received by the assessee himself or on his behalf. But under the mercantile system it would be taxable once the assessee gets the legal right to claim the amount. However, it has been specifically provided that in the case of income from salaries, the liability to tax arises immediately when the income is due to the assessee irrespective of the method of accounting followed. Likewise, in the case of dividends, the income would be included in total income of the shareholder under section 8 in the year in which the final dividend is declared and, in the case of interim dividend, in the year in which they are made unconditionally available to the shareholders.

Thus at this point of time to understand the incidence of tax efficiently it is essential to understand, which are the income that are deemed to be received in India, the meaning of income accruing or arising in India and the income deemed to accrue or arise in India.

Income accrued in India is chargeable to tax in all cases irrespective of residential status of an assessee. The words "accrue" and "arise" are used in contradistinction to the word "receive". Income is said to be received when it reaches the assessee; when the right to receive the income becomes vested in the assessee, it is said to accrue or arise.

2.5.1 Meaning of "Income Received or Deemed to be Received"

All assesses are liable to tax in respect of the income received or deemed to be received by them in India during the previous year irrespective of:

(i) their residential status, and

(ii) the place of its accrual.

Income is to be included in the total income of the assessee immediately on its actual or deemed receipt. The receipt of income refers to only the first occasion when the recipient gets the money under his control. Therefore, when once an amount is received as income, remittance or transmission of that amount from one place or person to another does not constitute receipt of income in the hands of the subsequent recipient or at the place of subsequent receipt.

Income Deemed to be Received

Under section 7, the following shall be deemed to be received by the assessee during the previous year irrespective of whether he had actually received the same or not -

(i) The annual accretion in the previous year to the balance to the credit of an employee participating in a Recognised Provident Fund (RPF). Thus, the contribution of the employer in excess of 12% of salary or interest credited in excess of 9.5% p.a. is deemed to be received by the assessee.

(ii) The taxable transferred balance from unrecognized to recognized provident fund (being the employer's contribution and interest thereon).

(iii) The contribution made by the Central Government or any other employer in the previous year to the account of an employee under a pension scheme referred to under section 80CCD.

2.5.2 Meaning of Income 'Accruing' and 'Arising'

Accrue refers to the right to receive income, whereas due refers to the right to enforce payment of the same. For e.g. salary for work done in December will accrue throughout the month, day to day, but will become due on the salary bill being passed on 31st December or 1st January. Similarly, on Government securities, interest payable on specified dates arise during the period of holding, day to day, but will become due for payment on the specified dates.

Example: Interest on Government securities is usually payable on specified dates, say on 1st January and 1st July. In all such cases, the interest would be said to accrue from 1st July to 31st December and on 1st January, it will fall due for payment.

It must be noted that income which has been taxed on accrual basis cannot be assessed again on receipt basis, as it will amount to double taxation. For example, when a loan to a director has already been treated as dividend under section 2(22) (e) and later dividend is declared, distributed and adjusted against the loan, the same cannot be treated as dividend income again.

With a view to removing difficulties and clarifying doubts, the taxation of income, provides that an item of income accruing or arising outside India shall not be deemed to be received in India merely because it is taken into account in a balance sheet prepared in India.

Further, once an item of income is included in the assessee total income and subjected to tax on the ground of its accrual/deemed accrual or receipt, it cannot again be included in the person's total income and subjected to tax either in the same or in a subsequent year on the ground of its receipt – whether actual or deemed.

2.5.3 Income Deemed to Accrue or Arise in India (Section 9)

Certain types of income are deemed to accrue or arise in India even though they may actually accrue or arise outside India. The categories of income which are deemed to accrue or arise in India are:

Any income accruing or arising to an assessee in any place outside India whether directly or indirectly

- Through or from any business connection in India,
- Through or from any property in India,
- Through or from any asset or source of income in India or
- Through the transfer of a capital asset situated in India.

Did u know? The legislative intent of this clause relating to the transfer of a capital asset situated in India is to cover incomes, which are accruing or arising, directly or indirectly from a source in India. The section codifies the source rule of taxation, which signifies that where a corporate structure is created to route funds, the actual gain or income arises only in consequence of the investment made in the activity to which such gains are attributable and not the mode through which such gains are realized.

This principle which supports the source country's right to tax the gains derived from offshore transactions where the value is attributable to the underlying assets, is recognized internationally by several countries.

Consequently, Explanation 4 of the section has been inserted to clarify that the expression "through" shall mean and include and shall be deemed to have always meant and included "by means of", "in consequence of" or "by reason of".

Further, Explanation 5 has been inserted to clarify that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India.

(i) Income, which falls under the head "Salaries", if it is earned in India. Any income under the head "Salaries" payable for rest period or leave period which is preceded and succeeded by services rendered in India, and forms part of the service contract of employment, shall be regarded as income earned in India.

(ii) Income from 'Salaries' which is payable by the Government to a citizen of India for services rendered outside India. However, allowances and perquisites paid outside India by the Government are exempt.

(iii) Dividend paid by an Indian company outside India.

(iv) Interest

(v) Royalty

(vi) Fees for technical services

The above mentioned categories of different of income which are deemed to accrue or arise in India are further explained in the subsequent section. Thus the categorisation of income which is deemed to accrue or arise in India can be summarised as below:

Nature of income	Whether income is deemed to accrue or arise in India
Income from business connection in India	Yes
Income from any property, asset or source of income in India	Yes
Capital gain on transfer of a capital asset situated in India	Yes
Income from salary if service is rendered in India	Yes
Income from salary (not being perquisite/allowance) if service is rendered outside India (provided the employer is Government of India and the employee is a citizen of India)	Yes
Income from salary if service is rendered outside India (not being a case stated above)	No
Dividend paid by the Indian company	Yes

Nature of Income	From whom Income is Received	Payer's Source of Income	Yes
Interest	Government of India	Any	Yes
Interest	A person resident in India	Borrowed capital is used by the payer for carrying on business/profession outside India or earning any income outside India	No
Interest	A person resident in India	Borrowed capital is used by the payer for any other purpose	Yes
Interest	A person non-resident in India	Borrowed capital is used by the payer for carrying on business/profession in India	Yes
Interest	A person non-resident in India	Borrowed capital is used by the payer for any other purpose	No

Contd...

Royalty/fees for technical services	Government of India	Any	Yes
Royalty/fees for technical services	A person resident in India	Payment is relatable to a business or profession or any other source carried by the payer outside India	No
Royalty/fees for technical services	A person resident in India	Payment is relatable to any other source of income	Yes
Royalty/fees for technical services	A person non-resident in India	Payment is relatable to a business or profession or any other source carried by the payer in India	Yes
Royalty/fees for technical services	A person non-resident in India	Payment is relatable to any other source of income	No

Example: For the assessment year 2006–07 (previous year 2005–06), X is employed in India and receives ₹ 24,000 as salary. His income from other sources includes:

Dividend received in London on June 3, 2005: ₹ 31,000 from a foreign company; share of profit received in London on December 15, 2005 from a business situated in Sri Lanka but controlled from India:

₹ 60,000; remittance from London on January 15,2006 out of past untaxed profit of 2003–04 earned and received there: ₹ 30,000 and interest earned and received in India on May 11, 2006: ₹ 76,000. Find out his gross total income, if he is (a) resident and ordinarily resident, (b) resident but not ordinarily resident, and (c) non-resident for the assessment year 2006–07.

If X is resident and ordinarily resident, his gross total income will be ₹ 1,15,000 (i.e., ₹ 24,000 + ₹ 31,000 + ₹ 60,000). If X is resident but not ordinarily resident, his gross total income will work out to be ₹ 84,000 (i.e., ₹ 24,000 + ₹ 60,000). If X is non-resident, his gross total income will come to ₹ 24,000.

Notes

1. The remittance from London of ₹ 30,000 is not taxable in the previous year 2005–06 because it does not amount to "receipt" of income.
2. Although the interest of ₹ 76,000 earned and received in India is taxable, it is not included in the total income of the assessment year 2006–07, as it is not earned or received in the previous year 2005–06. It will, therefore, be included in the total income of X for the assessment year 2007–08.

Self Assessment

Fill in the blanks:

18. The ……………. of accounting an income would be taxable only when it is received by the assessee himself or on his behalf.
19. …………. refers to the right to receive income.
20. …………….. to Section 5 specifically provides that an item of income accruing or arising outside India shall not be deemed to be received in India merely because it is taken into account in a balance sheet prepared in India.

21. Income from salary (not being perquisite/allowance) if service is rendered outside India (provided the employer is Government of India and the employee is a citizen of India) is deemed to accrue or arise in ……………….

2.6 Categories of Income which are Deemed to Accrue or Arise in India

There are seven main categories of income which are deemed to accrue or arise in India even though they may actually accrue or arise outside India. These are explained below:

1. ***Income from business connection:*** The expression "business connection" has been explained in Explanation 2 to section 9(1)(i) to encompass the following:

   (i) 'Business connection' shall include any business activity carried out through a person acting on behalf of the non-resident.

   (ii) He must have an authority which is habitually exercised to conclude contracts on behalf of the non-resident. However, if his activities are limited to the purchase of goods or merchandise for the non-resident, this provision will not apply.

   (iii) Where he has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident, a business connection is established.

   (iv) Business connection is also established where he habitually secures orders in India, mainly or wholly for the non-resident. Further, there may be situations when other non-residents control the above-mentioned non-resident. Secondly, this non-resident may also control other non-residents. Thirdly, all other non-residents may be subject to the same common control, as that of the non-resident. In all the three situations, business connection is established, where a person habitually secures orders in India, mainly or wholly for such non-residents.

Caution The following exceptions must be kept in mind while dealing with income from business connection:

"Business connection", however, shall not be held to be established in cases where the non-resident carries on business through a broker, general commission agent or any other agent of an independent status, if such a person is acting in the ordinary course of his business.

A broker, general commission agent or any other agent shall be deemed to have an independent status where he does not work mainly or wholly for the non-resident. He will however, not be considered to have an independent status in the three situations explained in (iv) above, where he is employed by such a non-resident.

Where a business is carried on in India through a person referred to in (ii), (iii) or (iv) mentioned above, only so much of income as is attributable to the operations carried out in India shall be deemed to accrue or arise in India.

2. ***Income from property, asset or source of income***: Any income which arises from any property which may be either movable, immovable, tangible or an intangible property would be deemed to accrue or arise in India.

Example: Hire charges or rent paid outside India for the use of the machinery or buildings situated in India, deposits with an Indian company for which interest is received outside India etc.

3. ***Income through the transfer of a capital asset situated in India:*** Capital gains arising from the transfer of a capital asset situated in India would be deemed to accrue or arise in India in all cases irrespective of the fact whether (i) the capital asset is movable or immovable, tangible or intangible; (ii) the place of registration of the document of transfer etc., is in India or outside; and (iii) the place of payment of the consideration for the transfer is within India or outside.

   Explanation 1 to section 9(1)(i) lists out income which shall not be deemed to accrue or arise in India. They are given below:

   a. *In the case of a business, in respect of which all the operations are not carried out in India: Explanation 1(a) to section 9(1)(i)***:** In the case of a business of which all the operations are not carried out in India, the income of the business deemed to accrue or arise in India shall be only such part of income as is reasonably attributable to the operations carried out in India. Therefore, it follows that such part of income which cannot be reasonably attributed to the operations in India, is not deemed to accrue or arise in India.

   b. *Purchase of goods in India for export: Explanation 1(b) to section 9(1)(i):* In the case of a non-resident, no income shall be deemed to accrue or arise in India to him through or from operations which are confined to the purchase of goods in India for the purpose of export.

   c. *Collection of news and views in India for transmission out of India: Explanation 1(c) to section 9(1)(i):* In the case of a non-resident, being a person engaged in the business of running a news agency or of publishing newspapers, magazines or journals, no income shall be deemed to accrue or arise in India to him through or from activities which are confined to the collection of news and views in India for transmission out of India.

   d. *Shooting of cinematograph films in India: Explanation 1(d) to section 9(1)(i):* In the case of a non-resident, no income shall be deemed to accrue or arise in India through or from operations which are confined to the shooting of any cinematograph film in India, if such non-resident is :

      - an individual, who is not a citizen of India or
      - a firm which does not have any partner who is a citizen of India or who is resident in India; or
      - a company which does not have any shareholder who is a citizen of India or who is resident in India.

4. ***Income from salaries:*** Under section 9(1)(ii) income which falls under the head 'salaries', would be deemed to accrue or arise in India, if it is in respect of services rendered in India. Thus Section 9 (1)(ii) of the Act requires that salaries is to be considered as deemed to be accrued or arise in India only if it is "earned in India".

   Further, the salaries payable for services rendered in India shall be regarded as income earned in India, though it may be paid in India or outside i.e. the payment or receipt of salary is immaterial. What is important is the place of rendering of services. Section 9(2) makes an exception to the aforesaid rule in the case of certain retired civil servants and judges permanently residing outside India.

Section 9(1)(iii) provides that the salaries are chargeable to tax if the same is payable by the Government to a Indian Citizen for services rendered outside India. The residential status and the place of receipt of salary are not relevant for the purpose of this sub-section. For income to be treated as deemed to accrue or arise in India following four conditions needs to be satisfied:

- Income should be chargeable under the head "Salaries"
- Salary should be payable by Government of India
- The recipient should be an Indian Citizen, irrespective of their residential status
- The services should be rendered outside India

> *Notes* It is important to note that all allowances or perquisites paid out side India by the Government to the Indian Citizens for their rendering services outside India are exempt under section 10(7).

5. ***Income from dividends:*** All dividends paid by an Indian company must be deemed to accrue or arise in India. Under section 10(34), income from dividends referred to in section 115-O are exempt from tax in the hands of the shareholder. It may be noted that dividend distribution tax under section 115-O does not apply to deemed dividend under section 2(22) (e), which is chargeable in the previous year in which such dividend is distributed or paid.

6. ***Interest:*** Under section 9(1)(v), an interest is deemed to accrue or arise in India if it is payable by -

   (i) the Central Government or any State Government.

   (ii) a person resident in India except where it is payable in respect of any money borrowed and used for the purposes of a business or profession carried on by him outside India or for the purposes of making or earning any income from any source outside India

   (iii) a non-resident when it is payable in respect of any debt incurred or moneys borrowed and used for the purpose of a business or profession carried on in India by him. Interest on money borrowed by the non-resident for any purpose other than a business or profession, will not be deemed to accrue or arise in India. Thus, if a non-resident 'A' borrows money from a non-resident '13' and invests the same in shares of an Indian company, interest payable by 'A' to '13' will not be deemed to accrue or arise in India.

7. ***Royalty:*** Royalty will be deemed to accrue or arise in India when it is payable by:

   (i) the Government; or

   (ii) a person who is a resident in India except in cases where it is payable for the transfer of any right or the use of any property or information or for the utilization of services for the purposes of a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India; or

   (iii) a non-resident only when the royalty is payable in respect of any right, property or information used or services utilised for purposes of a business or profession carried on in India or for the purposes of making or earning any income from any source in India.

Notes

Lump sum royalty payments made by a resident for the transfer of all or any rights including the granting of a license in respect of computer software supplied by a non-resident manufacturer along with computer hardware under any scheme approved by the Government under the Policy on Computer Software Export, Software Development and Training, 1986 shall not be deemed to accrue or arise in India.

Did u know? Computer software means any computer programme recorded on any disc, tape, perforated media or other information storage device and includes any such programme or any customised electronic data.

The term 'royalty' means consideration also including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head 'Capital gains' for:

(i) the transfer of all or any rights including the granting of license, in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property;

(ii) the imparting of any information concerning the working of, or the use of, a patent, invention, model, design, secret formula or process or trade mark or similar property;

(iii) the use of any patent, invention, model, design, secret formula or process or trade mark or similar property;

(iv) the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill;

(v) the use or right to use any industrial, commercial or scientific equipment but not including the amounts referred to in section 441313;

(vi) the transfer of all or any rights including the granting of license, in respect of any copyright, literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting, but not including consideration for the sale, distribution or exhibition of cinematographic films;

(vii) the rendering of any service in connection with the activities listed above.

The definition of 'royalty' for this purpose is wide enough to cover both industrial royalties as well as copyright royalties. The deduction specially excludes income which should be charge-able to tax under the head 'capital gains'.

Consideration for use or right to use of computer software is royalty within the meaning of section 9(1)(vi).

As per section 9(1) (vi), any income payable by way of royalty in respect of any right, property or information is deemed to accrue or arise in India. The term "royalty" means consideration for transfer of all or any right in respect of certain rights, property or information. There have been conflicting court rulings on the interpretation of the definition of royalty, on account of which there was a need to resolve the following issues–

Does consideration for use of computer software constitute royalty?

(i) Is it necessary that the right, property or information has to be used directly by the payer?

(ii) Is it necessary that the right, property or information has to be located in India or control or possession of it has to be with the payer?

(iii) What is the meaning of the term "process"?

In order to resolve the above issues arising on account of conflicting judicial decisions and to clarify the true legislative intent, Explanations 4, 5 & 6 have been inserted with retrospective effect from 1st June, 1976.

Explanation 4 clarifies that the consideration for use or right to use of computer software is royalty by clarifying that, transfer of all or any rights in respect of any right, property or information includes and has always included transfer of all or any right for use or right to use a computer software (including granting of a licence) irrespective of the medium through which such right is transferred.

Consequently, the provisions of tax deduction at source under section 194J and section 195 would be attracted in respect of consideration for use or right to use computer software since the same falls within the definition of royalty.

Notes The Central Government has, vide Notification No.21/2012 dated 13.6.2012 to be effective from 1st July, 2012, exempted certain software payments from the applicability of tax deduction under section 194J. Accordingly, where payment is made by the transferee for acquisition of software from a resident-transferor, the provisions of section 194J would not be attracted if:

1. the software is acquired in a subsequent transfer without any modification by the transferor;
2. tax has been deducted either under section 194J or under section 195 on payment for any previous transfer of such software; and
3. the transferee obtains a declaration from the transferor that tax has been so deducted along with the PAN of the transferor.

Explanation 5 clarifies that royalty includes and has always included consideration in respect of any right, property or information, whether or not,

(a) the possession or control of such right, property or information is with the payer;

(b) such right, property or information is used directly by the payer;

(c) the location of such right, property or information is in India.

Explanation 6 clarifies that the term "process" includes and shall be deemed to have always included transmission by satellite (including up-linking, amplification, conversion for down-linking of any signal), cable, and optic fibre or by any other similar technology, whether or not such process is secret.

8. ***Fees for technical services:*** Any fees for technical services will be deemed to accrue or arise in India if they are payable by -

(i) the Government.

(ii) a person who is resident in India, except in cases where the fees are payable in respect of technical services utilised in a business or profession carried on by such person outside India or for the purpose of making or earning any income from any source outside India.

(iii) a person who is a non-resident, only where the fees are payable in respect of services utilised in a business or profession carried on by the non-resident in India or where such services are utilised for the purpose of making or earning any income from any source in India.

A fee for technical services means any consideration (including any lump sum consideration) for the rendering of any managerial, technical or consultancy services (including providing the services of technical or other personnel). However, it does not include consideration for any construction, assembly, mining or like project undertaken by the recipient or consideration which would be income of the recipient chargeable under the head 'Salaries'.

Income deemed to accrue or arise in India to a non-resident by way of interest, royalty and fee for technical services to be taxed irrespective of territorial nexus (Explanation to section 9).

Income by way of interest, royalty or fee for technical services which is deemed to accrue or arise in India by virtue of clauses (v), (vi) and (vii) of section 9(1), shall be included in the total income of the non-resident, whether or not:

(i) the non-resident has a residence or place of business or business connection in India; or

(ii) the non-resident has rendered services in India.

In effect, the income by way of fee for technical services, interest or royalty, from services utilized in India would be deemed to accrue or arise in India in case of a non-resident and be included in his total income, whether or not such services were rendered in India.

Self Assessment

State whether the following statements are true or false:

22. The expression "business connection" has been explained in Explanation 2 to section 9(1)(i)
23. Any income which arises from any property which may be either movable, immovable, tangible or an intangible property would not considered to be deemed to accrue or arise in India.
24. All dividends paid by an Indian company must be deemed to accrue or arise in India.
25. The term 'royalty' means consideration also including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head 'Capital gains'.

Case Study

Make It Count: Residential Status Key to Taxation

An individual is taxed in India based on his tax residential status — which, in turn, depends on the number of days he is in India during a tax year (April 1 to March 31). Based on this calculation, an individual may be Resident and Ordinarily Resident (ROR), Resident but Not Ordinarily Resident (RNOR), or Non-resident (NR).

While an ROR is liable to tax in India on worldwide income, an RNOR or NR is taxed in India primarily on income sourced in India. It is vital to correctly determine an individual's

Contd...

tax residential status for a particular tax year — if not, he/she could end up paying tax on their worldwide income in India; or, their foreign income, which is liable to tax in India, could escape the tax net.

One is, therefore, faced with the task of keeping track of the days a person is in India during a tax year. The challenge is: how do you count the number of days in India?

Does one consider calendar days, or is every 24 hours spent on Indian soil counted as one day? Is only a full day spent in India counted as a day, or is a fraction of the day also counted? If a fraction of the day is to be counted as a whole day, are the days of arrival and departure both counted as days in India? What happens if one spends less than 24 hours in India during a trip?

The Income Tax Act and Rules do not offer any answers. However, this issue has previously been a subject of litigation, and one can draw guidance from the judicial authorities' interpretation of the term 'days in India'.

In the case of Manoj Kumar Reddy, the Bangalore Tribunal noted that while computing the period for which an assessee is in India, the count should begin from the date of arrival of the assessee in India *to* the date he leaves the country. The Tribunal drew guidance from the provisions of the General Clauses, Act and concluded that in counting days in this manner, the first day should be excluded. Hence, when counting the 'days', the day of arrival should be ignored.

The Bangalore Tribunal's view was followed by the Mumbai Tribunal in the case of Fausta C. Cordeiro, wherein it held that the arrival date is to be excluded from the count, particularly when the assessee arrived late in the day.

Based on the Tribunals' views, one may consider counting on the basis of calendar days, excluding the day of arrival but including the day of departure, even if it is a fraction of a day. Thus, if an individual arrives in the evening and leaves the next morning, he would have been in India (for tax purposes) for one day.

A word of caution: tax officials tend to count both the day of arrival and day of departure as 'days in India', irrespective of whether it is a full day or a few hours. Hence, the 'days in India' in the example above would be two days, not one.

So, when you zoom in and out of India on business or for pleasure, don't forget to keep a tab on your 'days in India', lest you are entangled in the tax net.

Questions

1. Study and analyse the case.
2. Write down the case facts.
3. What do you infer from it?

Source: http http://www.thehindubusinessline.com/industry-and-economy/taxation-and-accounts/make-it-count-residential-status-key-to-taxation/article4085396.ece

2.7 Summary

- Tax incidence on an assessee depends on his residential status. Whether an income earned by a foreign national in India or outside India taxable in India depends on the residential status of the individual, rather than on his citizenship. Therefore, the determination of the residential status of a person is very significant in order to find out his tax liability.
- There are three residential statuses that we will study in detail this unit namely the Residents also referred to as Resident & Ordinarily Residents, the Resident but not Ordinarily Residents and the Non-residents.

- Residential status of an assessee is to be determined in respect of each previous year as it may vary from previous year to previous year.
- An assessee may enjoy different residential status for different assessment years. For instance, an individual who has been regularly assessed as resident and ordinarily resident has to be treated as non-resident in a particular assessment year if he satisfies none of the conditions of section 6(1).
- Under section 6(1), an individual is said to be resident in India in any previous year, if he satisfies any one of the conditions like he has been in India during the previous year for a total period of 182 days or more, or he has been in India during the 4 years immediately preceding the previous year for a total period of 365 days or more and has been in India for at least 60 days in the previous year. If the individual satisfies any one of the conditions mentioned above, he is a resident. If both the above conditions are not satisfied, the individual is a non-resident also referred to as NRI.
- Only individuals and HUF can be resident but not ordinarily resident in India. All other classes of assesses can be either a resident or non-resident.
- An individual is said to be a resident and ordinarily resident if he satisfies both the following conditions: (i) He is a resident in any 2 out of the last 10 years preceding the relevant previous year, and (ii) His total stay in India in the last 7 years preceding the relevant previous year is 730 days or more.

  If the individual satisfies both the conditions mentioned above, he is a resident and ordinarily resident but if only one or none of the conditions are satisfied, the individual is a resident but not ordinarily resident.
- Every Indian company is resident in India irrespective of the fact whether the control and management of its affairs is exercised from India or outside. But a company, other than an Indian company, would become resident in India only if the entire control and management of its affairs is in India. The control and management of the affairs of company are said to be exercised from the place where the director's meetings (not shareholders' meetings) are held, decisions taken and directions issued.
- As per section 5, incidence of tax on a taxpayer depends on his residential status and also on the place and time of accrual or receipt of income. In order to understand the relationship between residential status and tax liability, one must understand the meaning of "Indian income" and "foreign income".
- The scope of total income of an assessee depends upon the following three important considerations like the residential status of the assessee, the place of accrual or receipt of income, whether actual or deemed and the point of time at which the income had accrued to or was received by or on behalf of the assessee.

2.8 Keywords

AOP: It is an entity or a unit of assessment which is includes two or more persons who join for a common purpose with a view to earn an income.

Company: It is an association or collection of individual real persons and/or other business entities, which each provide some form of capital.

Hindu Undivided Family (HUF): It is a legal term related to the Hindu Marriage Act.

Incidence of Tax: Tax incidence means the final burden of tax. In other words, incidence of tax is on person who actually bears or pays the final tax liability.

Income: It is the consumption and savings opportunity gained by an entity within a specified timeframe that is generally expressed in monetary terms.

Partnership Firm: It as a relation between two or more persons who have agreed to share the profits of a business carried on by all of them or any of them acting for all.

Receipt: The receipt of income refers to the first occasion when the recipient gets the money under his control.

Remittance: Remittance is transmission of income after its first receipt.

Royalty: It is consideration also including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head 'Capital gains'.

2.9 Review Questions

1. What do you understand by residential status of an individual? How is it related to incidence of an assessee?
2. Define the division of taxable entities for the purpose of determining residential status.
3. Discuss in detail the provisions for determining the residential status of an assessee.
4. Describe how you would determine the residential status of an assessee.
5. Write a note on residential status of a company.
6. Define incidence of tax as per section 5 of the income Tax Act 1961.
7. Differentiate between Indian and Foreign Income.
8. Explain the meaning of Income received or deemed to be received in India.
9. Mention the different categories of income which are deemed to accrue or arise in India.
10. X, an Indian citizen, leaves India on May 22, 2005 for vacation to Uganda and returns on April 9, 2006. Determine the residential status of X for the assessment year 2006–07.
11. Y, a foreign citizen, visits India since 1985 every year for a period of 100 days. Determine the residential status of Y for the assessment year 2006–07.
12. Rakesh was working as a crew member on an Indian ship plying in foreign waters. During the year ended 31.03.2008, the ship did not touch the Indian coast, except for 180 days. State the residential status for the assessment and taxability of his salary.
13. X got an employment in Singapore during the previous year 2008–09. He left for Singapore on August 9, 2008. He is an Indian Citizen. Determine the residential status for the Assessment Year 2009–10.
14. Following are the details of income of Mr. Subramani for the financial year 2009–2010:

Income from property in Sri Lanka remitted by the tenant to the assessee in India through SBI	₹ 2,10,000
Profit from business in India	₹ 1,00,000
Loss from business in Sri Lanka (whose control and management of business wholly remained in India)	₹ 80,000
Dividend from shares in foreign companies received outside India	₹ 60,000
Interest on deposits in India companies	₹ 1,20,000

Determine the total income in terms of the Income-tax Act, 1961 in the following situations:

(a) Resident and ordinarily resident of India;

(b) Resident but not ordinarily resident of India;

(c) Non-resident.

Answers: Self Assessment

1. C
2. A
3. A
4. B
5. True
6. False
7. True
8. True
9. False
10. Taxable
11. Taxable
12. Non-taxable
13. Non-taxable
14. Section 5
15. Residential status
16. India
17. Resident and ordinary resident
18. Cash system
19. Accrue
20. Explanation 1
21. India
22. True
23. False
24. True
25. True

2.10 Further Readings

Books

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Unit 3: Tax Planning: An Introduction

CONTENTS

Objectives

After studying this unit, you will be able to:

- Explain the concept of Tax Planning
- Define Corporate Tax Planning
- Describe Tax Evasion
- Discuss Tax Avoidance
- Trace the concept of Tax Management

Introduction

Tax planning involves conceiving of and implementing various strategies in order to minimize the amount of taxes paid for a given period. For a small business, minimizing the tax liability can provide more money for expenses, investment, or growth. In this way, tax planning can be a source of working capital. There are several general areas of tax planning that apply to all sorts of small businesses. These areas include the choice of accounting and inventory–valuation methods, the timing of equipment purchases, the spreading of business income among family members, and the selection of tax-favoured benefit plans and investments.

So, before one can embark on a study of the tax planning, it is absolutely vital to understand the meaning of tax planning and the concept of tax evasion, tax avoidance, tax planning and tax management. The purpose of this unit is to enable the students to comprehend basic expressions. Therefore, all such basic terms are explained and suitable illustrations are provided to define their meaning and scope.

3.1 Concept of Tax Planning

Tax planning is a broad term that is used to describe the processes utilized by individuals and businesses to pay the taxes due to local, state, and federal tax agencies. The process includes such elements as managing tax implications, understanding what type of expenses are tax deductible under current regulations, and in general planning for taxes in a manner that ensures the amount of tax due will be paid in a timely manner.

One of the main focuses of tax planning is to apply current tax laws to the revenue that is received during a given tax period. The revenue may come from any revenue producing mechanism that is currently in operation for the entity concerned. For individuals, this can mean income sources such as interest accrued on bank accounts, salaries, wages and tips, bonuses, investment profits, and other sources of income as currently defined by law. Businesses will consider revenue generated from sales to customers, stock and bond issues, interest bearing bank accounts, and any other income source that is currently considered taxable by the appropriate tax agencies.

Tax planning involves conceiving of and implementing various strategies in order to minimize the amount of taxes paid for a given period. For a small business, minimizing the tax liability can provide more money for expenses, investment, or growth. In this way, tax planning can be a source of working capital. Tax planning is not a device to reduce tax burden. In fact, it helps savings by investments in government securities. Savings reduce extravagance, and correspondingly inflation. Tax savings are permitted only for investment made in government securities and bonds of priority sectors which ultimately help the nation. Therefore, the savings in tax help the Central and state governments to mobilise funds by way of investments and as such the government earns much by way of other benefits, by sacrificing small amount of tax.

The Supreme Court in one case observed that "Tax planning may be legitimate provided it is within the framework of Law". By tax planning, the government is equally benefited.

Did u know? Basic rules applicable to tax planning for businesses:

1. First, a small business should never incur additional expenses only to gain a tax deduction. While purchasing necessary equipment prior to the end of the tax year can be a valuable tax planning strategy, making unnecessary purchases is not recommended.
2. Second, a small business should always attempt to defer taxes when possible. Deferring taxes enables the business to use that money interest-free, and sometimes even earn interest on it, until the next time taxes are due.

Tax planning is an essential part of your financial planning. Efficient tax planning enables you to reduce your tax liability to the minimum. This is done by legitimately taking advantage of all tax exemptions, deductions rebates and allowances while ensuring that your investments are in line with your long term goals.

In many cases, a primary goal of tax planning is to apply current laws in a manner that allows the individual or business to reduce the amount of taxable income for the period. Thus, planning for taxes involves knowing which types of income currently qualify for as exempt from taxation. The process also involves understanding what types of expenses may be legitimately considered as deductions, and what circumstances have to exist in order for the deduction to be claimed on the tax return.

Notes There are three common approaches to tax planning for the purpose of minimizing the tax burden.

The first is to reduce the adjusted gross income for the tax period. This is where understanding current tax laws as they relate to allowances and exemptions come into play.

A second approach to tax planning is to increase the amount of tax deductions. Again, this means knowing current laws and applying them when appropriate to all usual and normal expenses associated with the household or the business. Since these can change from one annual period to the next, it is always a good idea to check current regulations.

One final approach that may be applicable to effective tax planning has to do with the use of tax credits. This can include credits that relate to retirement savings plans, college expenses, adopting children, and several other credits.

3.1.1 General Areas of Tax Planning

There are several general areas of tax planning that apply to all sorts of small businesses. These areas include the choice of accounting and inventory-valuation methods, the timing of equipment purchases, the spreading of business income among family members, and the selection of tax-favoured benefit plans and investments. Some of the general taxes planning strategies are described below:

1. ***Accounting Methods:*** Accounting methods refer to the basic rules and guidelines under which businesses keep their financial records and prepare their financial reports.

There are two main accounting methods used for record-keeping: the cash basis and the accrual basis. Small business owners must decide which method to use depending on the legal form of the business, its sales volume, whether it extends credit to customers, and the tax requirements set forth by the Internal Revenue Service (IRS). The choice of accounting method is an issue in tax planning, as it can affect the amount of taxes owed by a small business in a given year.

Accounting records prepared using the cash basis recognises income and expenses according to real-time cash flow. Income is recorded upon receipt of funds, rather than based upon when it is actually earned, and expenses are recorded as they are paid, rather than as they are actually incurred. Under this accounting method, therefore, it is possible to defer taxable income by delaying billing so that payment is not received in the current year. Likewise, it is possible to accelerate expenses by paying them as soon as the bills are received, in advance of the due date. The cash method is simpler than the accrual method, it provides a more accurate picture of cash flow, and income is not subject to taxation until the money is actually received.

In contrast, the accrual basis makes a greater effort to recognize income and expenses in the period to which they apply, regardless of whether or not money has changed hands. Under this system, revenue is recorded when it is earned, rather than when payment is received, and expenses recorded when they are incurred, rather than when payment is made. The main advantage of the accrual method is that it provides a more accurate picture of how a business is performing over the long-term than the cash method. The main disadvantages are that it is more complex than the cash basis, and that income taxes may be owed on revenue before payment is actually received. However, the accrual basis may yield favourable tax results for companies that have few receivables and large current liabilities.

Some form of record-keeping is required by law and for tax purposes, but the resulting information can also be useful to managers in assessing the company's financial situation and making decisions. It is possible to change accounting methods later, but the process can be complicated. Therefore it is important for small business owners to decide which method to use up front, based on what will be most suitable for their particular business.

2. ***Cash vs. Accrual Basis:*** A taxpayer chooses his accounting method when he files his first income tax return. The Tax Code requires that taxpayers use a consistent method of accounting from year to year. Thus, if a taxpayer wishes to change its accounting method it must get permission to do so from the IRS. To request a change in accounting method you must file IRS Form 3115. This is a highly complex form and should not be completed without the assistance of a qualified CPA or tax attorney. The two most commonly used methods of accounting are the Accrual and the Cash methods. Each of these methods is discussed briefly under separate heading below:

   (a) *Cash Method:* The Cash Method of accounting allows taxpayers to report their revenues when received and expenses when paid. More than 95% of individual taxpayers use the Cash Method of accounting to report their taxable income and deductible expenses on their Forms 1040.

   (b) *Accrual Method:* Under the Accrual Method of accounting a taxpayer records his income when a sale occurs, not when payment is received. Likewise, he records a deductible expense when it's incurred, not when it's paid.

   A sale occurs when the following conditions are met:

   - All the events that establish a taxpayer's right to receive the income have happened; and

- The amount of income a taxpayer is to receive can be reasonably ascertained.

An expense is incurred when the following conditions are met:

- All the events that establish a taxpayer's obligation to pay it have occurred; and
- The amount of the expense to be paid can be reasonably ascertained.

The cash method of accounting lends itself to more planning opportunities because the taxpayer himself has control over when he pays his expenses and how fast he gets paid for his work.

Planning is more difficult under the accrual method because it's more difficult to change the objective fact of when a transaction is or is not complete. Regardless of whether you use the accrual or cash method of accounting, in November or December of every year you should consult with your tax planner to discuss options for deferring taxable income to a subsequent tax year and accelerating deductions to the current year.

Example: If you use the cash basis method of accounting your tax planner might suggest that you prepay certain expenses that you anticipate will come due early in the following tax year. Likewise, your tax advisor might suggest that you delay the issuance of invoices in order to defer income to the following tax year.

Since the recognition of revenues and expenses under the cash method depends upon the timing of various cash receipts and disbursements, however, it can sometimes provide a misleading picture of a company's financial situation. In contrast, the accrual basis makes a greater effort to recognize income and expenses in the period to which they apply, regardless of whether or not money has changed hands. Under this system, revenue is recorded when it is earned, rather than when payment is received, and expenses recorded when they are incurred, rather than when payment is made.

Example: Say that a contractor performs all of the work required by a contract during the month of May, and presents his client with an invoice on June 1. The contractor would still recognize the income from the contract in May, because that is when it was earned, even though the payment will not be received for some time.

The main advantage of the accrual method is that it provides a more accurate picture of how a business is performing over the long-term than the cash method. The main disadvantages are that it is more complex than the cash basis, and that income taxes may be owed on revenue before payment is actually received.

Notes Under generally accepted accounting principles (GAAP), the accrual basis of accounting is required for all businesses that handle inventory, from small retailers to large manufacturers. It is also required for corporations and partnerships that have gross sales over $5 million per year, though there are exceptions for farming businesses and qualified personal service corporations-such as doctors, lawyers, accountants, and consultants. A business that chooses to use the accrual basis must use it consistently for all financial reporting and for credit purposes. For anyone who runs two or more businesses, however, it is permissible to use different accounting methods for each.

3. ***Inventory Valuation Methods:*** The method a small business chooses for inventory valuation can also lead to substantial tax savings. Inventory valuation is important because businesses are required to reduce the amount they deduct for inventory purchases over the course of a year by the amount remaining in inventory at the end of the year.

Example: Mr. X that purchased ₹10,000 in furniture during the year but had ₹6,000 remaining in furniture at the end of the year could only count ₹4,000 as an expense for furniture purchases, even though the actual cash outlay was much larger. Valuing the remaining furniture differently could increase the amount deducted from income and thus reduce the amount of tax owed by the business.

The tax law provides two possible methods for inventory valuation: the first-in, first-out method (FIFO); and the last-in, first-out method (LIFO). As the names suggest, these inventory methods differ in the assumption they make about the way items are sold from inventory. FIFO assumes that the items purchased the earliest are the first to be removed from inventory, while LIFO assumes that the items purchased most recently are the first to be removed from inventory. In this way, FIFO values the remaining inventory at the most current cost, while LIFO values the remaining inventory at the earliest cost paid that year.

Did u know? LIFO is generally the preferred inventory valuation method during times of rising costs. It places a lower value on the remaining inventory and a higher value on the cost of goods sold, thus reducing income and taxes. On the other hand, FIFO is generally preferred during periods of deflation or in industries where inventory can tend to lose its value rapidly, such as high technology. Companies are allowed to file Form 970 and switch from FIFO to LIFO at any time to take advantage of tax savings. However, they must then either wait ten years or get permission from the IRS to switch back to FIFO.

4. ***Equipment Purchases:*** It is often advantageous for small businesses to use this tax incentive to increase their deductions for business expenses, thus reducing their taxable income and their tax liability. Necessary equipment purchases up to the limit can be timed at year end and still be fully deductible for the year.

Caution This tax incentive is also applicable to the personal property put into service for business use, but with the exception of automobiles and real estate.

5. ***Benefits Plans and Investments:*** Tax planning also applies to various types of employee benefits that can provide a business with tax deductions, such as contributions to life insurance, health insurance, or retirement plans. As an added bonus, many such benefit programs are not considered taxable income for employees. Finally, tax planning applies to various types of investments that can shift tax liability to future periods, such as treasury bills, bank certificates, savings bonds, and deferred annuities. Companies can avoid paying taxes during the current period for income that is reinvested in such tax-deferred instruments.

3.1.2 Tax Planning for Different Business Forms

"The first step in tax planning–for small business owners and professionals, at least–is to select the right form of organization for your enterprise," is according to Albert B. Ellentuck in the

Laventhol and Horwath Small Business Tax Planning Guide. "You'll end up paying radically different amounts of income tax depending on the form you select. And your odds of being audited by the IRS will change, too." There are also some areas of tax planning that are specific to certain business forms—i.e., sole proprietorships, partnerships, C corporations, and S corporations.

Many aspects of tax planning are specific to certain business forms. Some of these are discussed below:

(i) ***Sole Proprietorships and Partnerships:*** Tax planning for sole proprietorships and partnerships is in many ways similar to tax planning for individuals. This is because the owners of businesses organized as sole proprietors and partnerships pay personal income tax rather than business income tax. These small business owners file an informational return for their business with the IRS (Internal Revenue Service), and then report any income taken from the business for personal use on their own personal tax return.

Since they do not receive an ordinary salary, the owners of sole proprietorships and partnerships are not required to withhold income taxes for themselves. It is important that the amount of tax paid in quarterly instalments equal either the total amount owed during the previous year or 90 per cent of their total current tax liability. Otherwise, the IRS may charge interest and impose a stiff penalty for underpayment of estimated taxes.

Since the IRS calculates the amount owed quarterly, a large lump-sum payment in the fourth quarter will not enable a taxpayer to escape penalties. On the other hand, a significant increase in withholding in the fourth quarter may help, because tax that is withheld by an employer is considered to be paid evenly throughout the year no matter when it was withheld. This leads to a possible tax planning strategy for a self-employed person who falls behind in his or her estimated tax payments. By having an employed spouse increase his or her withholding, the self-employed person can make up for the deficiency and avoid a penalty. The IRS has also been known to waive underpayment penalties for people in special circumstances.

Example: They might waive the penalty for newly self-employed taxpayers who underpay their income taxes because they are making estimated tax payments for the first time.

Another possible tax planning strategy applies to partnerships that anticipate a loss. At the end of each tax year, partnerships file the informational Form 1065 (Partnership Statement of Income) with the IRS, and then report the amount of income. This income can be divided in any number of ways, depending on the nature of the partnership agreement. In this way, it is possible to pass all of a partnership's early losses to one partner in order to maximize his or her tax advantages.

(ii) ***C Corporations:*** Tax planning for C corporations is very different than that for sole proprietorships and partnerships. This is because profits earned by C corporations accrue to the corporation rather than to the individual owners, or shareholders. A corporation is a separate, taxable entity under the law, and different corporate tax rates apply based on the amount of net income received. Personal service corporations like medical and law practices, pay a flat rate of 35 per cent. In addition to the basic corporate tax, corporations may be subject to several special taxes.

Corporations must prepare an annual corporate tax return on either a calendar-year basis (the tax year ends December 31, and taxes must be filed by March 15) or a fiscal-year basis (the tax year ends whenever the officers determine). Most Subchapter S corporations, as well as C corporations that derive most of their income from the personal services of shareholders, are required to use the calendar-year basis for tax purposes. Most other corporations can choose whichever basis provides them with the most tax benefits. Using a fiscal-year basis to stagger the corporate tax year and the personal one can provide several advantages.

Example: Many corporations choose to end their fiscal year on January 31 and give their shareholder/employees bonuses at that time. The bonuses are still tax deductible for the corporation, while the individual shareholders enjoy use of that money without owing taxes on it until April 15 of the following year.

Both the owners and employees of C corporations receive salaries for their work, and the corporation must withhold taxes on the wages paid. All such salaries are tax deductible for the corporations, as are fringe benefits supplied to employees. Many smaller corporations can arrange to pay out all corporate income in salaries and benefits, leaving no income subject to the corporate income tax. Of course, the individual shareholder/employees are required to pay personal income taxes. Still, corporations can use tax planning strategies to defer or accrue income between the corporation and individuals in order to pay taxes in the lowest possible tax bracket. The one major disadvantage to corporate taxation is that corporate income is subject to corporate taxes, and then income distributions to shareholders in the form of dividends are also taxable for the shareholders. This situation is known as "double taxation."

(iii) ***S Corporations:*** Subchapter S corporations avoid the problem of double taxation by passing their earnings (or losses) through directly to shareholders, without having to pay dividends. Experts note that it is often preferable for tax planning purposes to begin a new business as an S corporation rather than a C corporation. Many businesses show a loss for a year or more when they first begin operations. At the same time, individual owners often cash out investments and sell assets in order to accumulate the funds needed to start the business. The owners would have to pay tax on this income unless the corporate losses were passed through to offset it.

Another tax planning strategy available to shareholder/employees of S corporations involves keeping FICA (Federal Insurance Contributions Act) taxes low by setting modest salaries for themselves, below the Social Security base. S corporation shareholder/employees are only required to pay FICA taxes on the income that they receive as salaries, not on income that they receive as dividends or on earnings that are retained in the corporation. It is important to note, however, that unreasonably low salaries may be challenged by the IRS.

The key objective in effective corporate tax planning is to identify the main factors in the organisation's structure that dictate the opportunities for tax efficiencies.

Caution What tax planning is not...

1. Tax Planning is NOT tax evasion. It involves sensible planning of your income sources and investments. It is not tax evasion which is illegal under Indian laws.
2. Tax Planning is NOT just putting your money blindly into any 80C investments
3. Tax Planning is NOT difficult. Tax Planning is easy. It can be practiced by everyone and with a very little time commitment as long as one is organized with their finances

3.1.3 Tax Planning Tips that can Assist Salaried People to Reduce Their Tax Accountability

Tax Planning India is an application to reduce tax liability through the finest use of all accessible allowances, exclusions, deductions, exemptions, etc., to trim down income and/or capital profits. Salaried individuals in India are not fully aware of the tax planning exercise which is why they rush at the end of the tax-planning season and make investments to reduce their tax liability. This has negative effect on tax payable by them and they eventually end up paying more taxes than they are required to.

1. ***Make full use of the entire Section 80C deduction:*** The maximum reduction available in Section 80C is ₹ 1,00,000 and salaried citizens whose gross salary is ₹ 2,50,000 or more are entitled to use the full ₹ 1,00,000 limit. Individuals who make monetary infusions of over ₹ 1,00,000 in Section 80C in selected areas fail to understand that the advantages are limited. In spite of investing ₹ 70,000 and ₹ 40,000 in Public Provident Fund and ELSS (Equity Linked Savings Scheme) respectively, the amount entitled by the investor is only ₹ 1,00,000.

Notes Following investments/contributions meet the criteria for Section 80C reduction:

1. Public Provident Fund
2. Accrued interest on National Saving Certificate
3. Life Insurance Premium
4. National Saving Certificate
5. Tuition fees paid for children's education (maximum 2 children)
6. Principal component of home loan repayment
7. 5-Year fixed deposits with banks and Post Office
8. Equity Linked Savings Schemes (ELSS)

2. ***Reduction of tax liability beyond Section 80C deductions:*** If your salary surpasses ₹ 2,50,000 pa and the reductions under Section 80C are not enough to minimize the general tax liability consider the following:
   - *Home loan:* Interest payments of upto ₹ 1,50,000 pa are entitled for reduction under Section 24.
   - *Medical insurance:* A deduction of upto ₹ 15,000 pa under section 80D is applicable under this.
   - *Donations:* Tax advantages under Section 80G entitle the donations to particular funds/institutions.
3. ***Assert tax advantages on house rent paid:*** If HRA (House Rent Allowance) is not included in the salary structure then the salaried individuals can asset rent paid by them for residential lodging. This reduction is accessible under Section 80GG and is smallest amount of the following:
   - 25% of the total earnings or,
   - ₹ 2,000 every month or,
   - Surplus of housing charge paid over 10% of total salary.

4. ***Reorganize the salary:*** Reorganizing the salary and incorporating certain apparatus can help in the long run in minimizing the tax liability. In order to assert tax benefits salary reform is a more competent measure. The following can be included in an individual's salary structure:
   - Food coupons can release up to ₹ 60,000 per year from tax.
   - Medical expenses which are compensated by the employer spare up to ₹ 15,000 per year.
   - House Rent Allowance (HRA) should be incorporated in the salaries of individuals who stay in rented houses.
   - Transport allowance discharge upto ₹ 800 per month.
5. ***Go for a combined home loan:*** The primary reimbursement on a home loan is entitled for a reduction of up to ₹ 100,000 pa and the interest rewarded are entitled for a reduction of up to ₹ 150,000 pa. When a home loan is for a considerable amount then the interest and chief reimbursement surpass the allotted limit. A salaried individual can go for a combined joint home loan with his parent, spouse or sibling, to guarantee the best utilization of tax advantages.

   In this way both the owners can assert tax reductions in the percentage of their stake holding in the loan.

3.1.4 Different Types of Tax Planning Strategies

The goal of all tax planning strategies is to minimize an individual's or business' total tax liability for the year while also meeting personal or business financial goals. In order to achieve these goals, comprehensive research and exacting record keeping are essential elements of all types of successful planning strategies. An individual may not need to use every type of tax strategy, but having a broad knowledge of tax issues will assure that he minimizes his tax liability and prepares an accurate return. Whether it is taking advantage of current education-related tax credits or understanding the intricacies of depreciation, each strategy relies on thorough research and meticulous recordkeeping.

Investigating all aspects of income taxes — concentrating on the areas that pertain to the individual's financial situation — is the most important tax planning strategy. Many credits, deductions and limits on retirement or health savings accounts contributions change from year to year. Taxpayers often remain unaware of these changes and miss opportunities that they would qualify for. The most accurate and updated information can be accessed through the federal, state or local tax entity.

Whether using a tax professional, accountant, or self-preparing the return, implementing tax planning strategies and maintaining records throughout the year provides the individual or business with the necessary tools to minimize tax liability. This second important tax planning strategy allows the individual or business to accurately track their progress on their goals through precise record keeping. It also assures nothing is missed when it is time to prepare the tax return. Spreadsheets and financial software are tax-planning tools that help organize information. The software expense may be tax deductible.

Although the first two tax planning strategies apply to everyone, others are applicable depending on the individual's financial situation. Making sure that pre-tax contributions to retirement and health savings accounts are maximized and done within the allowed time span may help lower any tax liability. Homeowners should use strategies that take advantage of any credits available for expenses related to their residences.

Example: Property taxes and interest on mortgages are usually deductible expenses. Special tax credits may be temporarily available for improvements that increase the energy efficiency of the home, so taking advantage of these can also reduce tax liability.

College students, their families and anyone taking coursework should be aware of changes to the credits and deductions available for education-related expenses. The treatment of investment income and losses may change, too, so individuals might make advantageous adjustments based on current rules. Other tax planning strategies involve medical expenses, charitable contributions and adjustments to tax withholding amounts. Many people are unaware that deductions can be taken up to the amount of any earnings related to a hobby. In the same manner, gambling losses can be deducted up to the amount of gambling winnings.

Caselet

Company Director Failed to Pay Employees' Income Tax

The defendant was the director of two companies.

The Court was satisfied that at all material times the returns lodged by the defendant's companies were true and correct. There was no evidence of any false or misleading statements or evidence of their failure to pay being concealed.

The defendant's companies, in the usual fashion, deducted amounts from their employees' income for the purpose of satisfying income tax obligations. It appears, however, that due to severe cash flow issues, these amounts were never paid to the Commissioner.

The defendant was indicted on two charges of "Defrauding the Commonwealth" through not remitting in full the amounts owed to the Commissioner. In other words, the Commonwealth alleges that they were defrauded by the debtor's failure to pay their debt.

The debtor was sentenced to six months' periodic detention for the offences at first instance.

On appeal, the Court held that simply not paying a debt was not fraud in the absence of evidence that the defendant had somehow concealed either information or the non-payment of the debts. The Court said "in the present case... there was no evidence companies made any false or misleading statements to the Commissioner or concealed their failures to pay or that the Commissioner was deceived..." Thus the company's returns contained no fraudulent misrepresentations or non-disclosure, and in any event the Crown did not establish that they deprived the Commonwealth of the group tax or put that tax at risk.

On this basis the Court held that there was no defrauding of the Commonwealth and allowed the appeal, dismissing all the charges.

Source: http://www.armstronglegal.com.au/corporate-crime/tax-fraud/cases

Self Assessment

State whether the following statements are true or false:

1. Savings increase extravagance, and correspondingly inflation.
2. In Inventory Valuation Methods, a small business chooses for inventory valuation can also lead to substantial tax savings.
3. LIFO assumes that the items purchased the earliest are the first to be removed from inventory.

3.2 Corporate Tax Planning

Corporate tax refers to a tax levied by various jurisdictions on the profits made by companies or associations. As a general principle, the tax varies substantially between jurisdictions. In particular allowances for capital expenditure and the amount of interest payments that can be deducted from gross profits when working out the tax liability vary substantially. Also, tax rates may vary depending on whether profits have been distributed to shareholders or not. Profits which have been reinvested may not be taxed. The term "corporate tax planning" encompasses the strategic structuring of business operations in order to minimize tax liabilities. Corporate tax planning activities generally seek to avoid legally triggering tax costs rather than illegally evading an existing obligation to pay taxes. Tax planning represents a forward-looking activity, as opposed to tax compliance or reporting, which reflects back on events that have already taken place. Corporations typically engage certified public accountants or tax attorneys for technical advice in this complicated area. Basically Corporate Tax Planning is the strategies to reduce the taxes. Tax planning and management is a risky and complex issue. It is very much at high priority to deal with the taxes efficiently and effectively. There is indeed a need of perfect corporate tax planning that will really facilitate the smooth flow.

A fundamental aspect of corporate tax planning involves determining which particular countries, states and cities have the authority to impose tax on corporate activities. Each sovereign government maintains different rules for imposing tax, which means that jurisdictional arbitrage, can create tax cost differentials. Corporate tax planning opportunities oftentimes arise from identifying the appropriate time to recognize an item of income or expense. Deferral of income recognition to a future period or acceleration of expense deductions to current period result in positive cash flows and savings due to the time value of money. Strategically exploiting the discrepancies in rules for book accounting versus tax accounting may help create timing differences that produce tax benefits.

Corporate tax rate in India is at par with the tax rates of other nations of the world. The corporate tax rate in India is based on the origin of the company. If the company is domicile to India, then the tax rate is flat at 30%. But for a foreign company, then the tax rate depends on several other factors and considerations. For companies that are domicile to India, tax is charged on the global income whereas for the foreign companies present in India, tax is charged on their income within Indian Territory. Incomes that are taxable for foreign companies include income from the capital assets in India, interest gained, income from sale of equity shares of the company, royalties, dividends earned, etc.

3.2.1 Domestic Corporate Income Tax Rates

In case of Domestic Corporations, the effective taxes rate as well the tax rate with surcharge as is 30%. It should be noted that if the taxable income is greater than ₹ 1 million then a surcharge of 10% of the tax on income is also levied.

Notes It is important to note the fact that all the companies formed in India are considered as Indian domestic companies, even for ancillary units with mother companies in foreign countries.

3.2.2 Foreign Companies Income Tax Rates

Following are the Foreign Companies income tax rates:

- ***For dividends:*** 20% for non-treaty foreign companies and 15% in case of companies under the treaty based in the United States
- ***For interest gains:*** 20% for non-treaty foreign companies and 15% for companies under the treaty based in the United States
- ***For royalties:*** 30% for non-treaty foreign companies and 20% for companies under the treaty based in the United States
- For the technology based services in case of non-treaty foreign companies and 20% for companies under the treaty based in the United States
- ***For all other kinds of income and gains:*** 55% in case of non-treaty foreign companies and 55% for the companies under the treaty based in the United States
- Attention should be given on levying inter corporate rates in case holding is minimum
- Attention should be given on the fact that sanctions of the tax authorities on tax withholding
- Attention should be given on several of the tax treaties that India signed with other countries and also on the various encouraging tax rates

3.2.3 Tax Rebates under Corporate Tax Rate

Some of the tax rebates under corporate tax rate in India:

- Gains pertaining to long term capital are subject to low tax incidence
- Venture capital funds and venture capital companies have special tax provisions
- Specula tax provisions are applicable for non-resident Indians involved in activities in India
- Under the Finance Bill 1996, the Minimum Alternative Tax (MAT) is levied on the corporate sector

Taxes can eat away at business profits. To address it, small business owners and corporate leaders look for ways to reduce their tax liability—and the tax planning process is an integral part of this activity.

(i) ***Identification:*** Tax planning is the act of developing a plan to minimize or defer taxes paid against current business revenue or income. The planning process includes understanding all local, state and federal tax obligations, determining which deductions are available and how and when to pay each tax.

(ii) ***Function:*** The essence of tax planning is determining how to maximize tax deductions against current revenue. Options include, but are not limited to, deductions associated with incorporation status (sole proprietorship, S-corporation, LLC or C-corporation), capital expenditures and setting up 401(k) plans for employees. Business owners use the tax planning process to find and take advantage of all deductions available.

(iii) ***Significance:*** Companies decide whether to expand and hire new employees based on their tax burden. For this reason, tax planning is crucial and business owners do it religiously every year.

Wise corporate officials take time to perform due diligence in researching the availability of tax reducers, such as deduction and credits. They will use this research to design business activities to qualify for these reducers as often as possible. Corporate officials also can minimize tax liability by strategically locating business activities where they can take advantage of low tax environments, deductions and credits.

3.2.4 Case for Levy of Corporate Tax

Under a system of general income taxation, whether companies should be taxed independently as separate entitles has been the subject matter of prolonged debate among tax economists. One view is that since corporations are not persons, strictly speaking, there is no case in equity for taxing the profits of companies as such. The tax should be levied only on the owners, that is, the equity holders, by attributing the profits of the companies to the shareholders. Such a system, however, can operate smoothly only if all profits are distributed every year among the shareholders. Where part of the profits is retained, the gain to the shareholders accruing from appreciation in the value of equities escapes taxation unless there is an effective tax on realised capital gains or unless the undistributed profits are attributed notionally to the shareholders. This is not simple in the case of large corporations in which the shares undergo sale or transfer all the time.

Since capital gains are usually treated preferentially, even where the income tax is levied on capital gains, exclusion of retained profits of companies from taxation provides an easy way of avoiding taxation by accumulating profits under the corporate cover. Taxation on the basis of attribution also encounters problems in the determination of capital gains when the shares are transferred, as the cost basis has to be adjusted annually to take account of the notional distribution of accumulated profits underlying the capital gain. Besides, taxation on notional basis gives rise to liquidity problems and hence does not seem equitable or feasible. It is therefore generally accepted that some tax has to believe on the profits of companies so long as individuals and unincorporated enterprises are subjected to tax on their profits.

Taxation of companies as separate entities is also justified as a withholding tax, which may be a useful means of ensuring that income flowing through the conduit is taxed in a comprehensive and timely manner and that the base of the individual income tax is protected. Many economists, including some who have not advocated full integration, have argued that this withholding function is indeed the main argument for the imposition of a tax on corporate income.

A separate tax on the profits of companies is considered reasonable also on the ground that incorporation confers substantial benefits such as limited liability of shareholders, right to sue and be sued and so on. What is more, corporate taxation is an administratively simple device for taxing an important type of income from capital.

Self Assessment

Fill in the blanks:

4. ………………………Planning is the strategies to reduce the taxes.
5. Corporate officials also can …………………..tax liability by strategically locating business activities.
6. Taxation on notional basis gives rise to ………………..problems.

Notes

3.3 Tax Evasion

Tax evasion as the term refers to the phenomenon of evading tax. Tax evasion is the general term for efforts by individuals, firms, trusts and other entities to evade taxes by illegal means. Tax evasion usually entails taxpayers deliberately misrepresenting or concealing the true state of their affairs to the tax authorities to reduce their tax liability, and includes, in particular, dishonest tax reporting (such as declaring less income, profits or gains than actually earned; or overstating deductions).

Example: Some entities collect revenue in cash and do not record the same. The logic behind not disclosing the true income is to avoid paying taxes on the non- recorded income. This example is a clear example of tax evasion and is an illegal act. Tax avoidance on the other hand is a legal activity.

Tax evasion is usually understood to be an act in which an individual intentionally chooses to not pay income taxes due. This act of not paying taxes may be conducted by simply chooses to not file an income tax return, or choosing to not include information about taxable income on the filed return. In all instances, tax evasion can be considered to be fraud, and usually carries stiff penalties.

Caution Tax evasion is illegal, so those engaging in it have every reason to seek to conceal what they are doing. This introduces a fundamental difficulty into the measurement of tax evasion. Even so, the fact that the estimates those are available show evasion to constitute a significant part of total economic activity underline the importance of measurement. The lost revenue due to tax evasion also emphasizes the value of developing a theory of evasion that can be used to design a tax structure that minimizes evasion and ensures that policy is optimal given evasion occurs.

While there are some that consider any type of omission from the tax return to constitute tax evasion, it is important to remember that it is possible to omit an item simply because the data was overlooked when filing the return. Thus, the intent of the individual plays a key role in determining if tax evasion has taken place. When the return fails to include information simply because the filer overlooked the data, there is a good chance that the tax agency will still impose a fine of some sort, but no further action would be taken.

However, when it can be demonstrated that the individual wilfully attempted to hide information about income that was subject to withholding, the tax agency may choose to impose more than a simple interest fine on the amount omitted. The filer may be subject to stiff fines associated with the deliberate failure to file an accurate tax return, or even possibly face prosecution and some time spent in jail for the intentional negligence.

Tax evasion is considered a crime, and is often classified as fraud. All citizens suffer from tax evasion, as the act prevents the government from collecting funds to use for the operation of essential services to the population. When these funds are not collected, services have to be curtailed and thus result in a lower quality of life for all citizens.

Persons who become aware of an error on calculating taxes on reported income or notice that income was inadvertently left off the tax return for a given period should contact the tax agency and make arrangements to file an amended return as soon as possible. This will help to minimize the chances of being suspected of tax evasion, and allow the matter to be settled before interest charges become significant.

Notes Some of the Instances of Tax Evasion relate to failing and claiming:

Failing to:

1. report all income
2. report cash wages
3. forward tax withheld from employee's wages to the ATO
4. withhold tax from a worker's wages – for example, paying cash in hand
5. pay employee super entitlements
6. lodge tax returns, in an attempt to avoid payment
7. lodge a tax return in order to avoid child support or other obligations

Claiming:

1. deductions for expenses not incurred or legally deductible
2. input credits for goods or services that GST has not been paid on.

3.3.1 Importance of Tax Evasion

Tax evasion is important for many reasons:

(i) It reduces tax collections, thereby affecting taxes that compliant taxpayers face and public services that citizens receive.

(ii) Evasion creates misallocations in resource use when individuals and firms alter their behaviour to cheat on their taxes.

(iii) Its presence requires that government expend resources to deter noncompliance, to detect its magnitude, and to penalize its practitioners.

(iv) Tax evasion alters the distribution of income unpredictably; unless tax evaders are caught, they pay fewer taxes than honest taxpayers. Evasion may contribute to feelings of unfair treatment and disrespect for the law, creating a self-generating cycle that feeds upon itself and leads to even more evasion. It affects the accuracy of macroeconomic statistics.

(v) More broadly, it is not possible to understand the true impact of taxation without recognizing the existence of evasion.

3.3.2 Causes of Tax Evasion

Following are the causes of Tax Evasion:

(i) ***Controls and Licensing System:*** The system of controls, permits, quotas and licenses which are associated with misdistributions of the commodities in short supply results in the generation of black money which leads to tax evasion. Since, considerable discretionary powers lay in the hands of those who administered controls this provided them with a scope for corruption – 'speed money' for turning a blind eye to the violation of controls. All this gave rise to trading in permits, quotas and licenses, malpractices in distribution and in the process; it generated sizeable sums of black money." Price and distribution controls have in the past led to the generation of black money on a significant scale.

Did u know? Any price control without any adequate machinery of distribution and speedy arrangement for increasing supplies is potentially a source of black money generation.

(ii) ***Tax Structure:*** High tax rates and defective tax structure is a major cause of tax evasion. An individual has to pay a substantial amount of taxes on his salary and when he invests the remaining salary, the profit earned is also taxable. This is not the least, on every purchase of any product and commodities he pays the various taxes attached with it. This is annoying to an individual which encourages him to default taxes. Honest assesses are not aware how to file tax returns. This may lead to tax evasion.

(iii) ***Donation to Political Parties:*** Ever since the Government decided to ban donations to political parties in 1968, it prompted businessmen to fund political parties, especially the ruling party, with the help of black money. Ostensibly, this decision was taken to reduce the influence of big business on the electoral process, but in practice what happened was precisely the opposite. Businessmen everywhere have by now learnt that they should pay a certain charge out of the black money to the coffers of political parties and then be sure that the political leaders will only bark but not bite.

Did u know? The political instability witnessed in the country in – various states has resulted in widespread horse–trading of the MLAs at the state levels and MPs at the Central level. In this process of buying political support, black money plays a crucial role. Consequently the determination of the ruling political party to curb black money has become very weak. As a consequence, businessmen feel they have an unfettered license to spin black money, pay a small part to the political parties as donations and then enjoy the rest the way they like. Unless the link between black money and political power is broken, there is no hope of controlling the generation of black money or its link with crime.

(iv) ***Ineffective Enforcement of Tax Laws:*** Whereas the Government has an armoury of tax laws pertaining to income tax, sales tax, stamp duties, excise duty etc., their enforcement is very weak due to widespread corruption in these departments. . The high rates of these taxes induce businessmen to avoid recording of these transactions. This evasion largely goes unchecked and thus sets in a chain reaction for the generation of black money at the wholesale, retail as well as production levels.

(v) ***Generation of Black Money in the Public Sector:*** Every successive five-year plan is planned for a larger size of investment in the public sector. The projects undertaken by the public sector have to be monitored by the bureaucrats in Government departments and public sector undertakings. Tenders are invited for the various works and these tenders are awarded by the bureaucracy in consultation with the political bosses. Thus, a symbiotic relationship develops between the contractors, bureaucracy and the politicians and by a large number of devices costs 'are artificially escalated and black money is generated by underhand deals. Instability of the political system has given a further momentum to this process. Since the ministers are not sure of their tenure and in a majority of cases, the tenure is very short, the principle 'Make hey while the sun shines' is adopted by most of them. The larger numbers of scandals that are unearthed by the Opposition only support the contention that huge investment in the public sector is a big potential source for black money generation. In this process, bureaucrats act as brokers for political leaders and thus the nexus between business, bureaucracy and politicians promotes the generation of black money.

(vi) ***Ceiling on Depreciation and Other Business Expenses:*** Government has imposed restriction. It has also circumscribed expenses on advertisement, entertainment, guest houses, and payment of perquisites to directors. The purpose of these restrictions is to protect the shareholders and consumers from the unscrupulous action of businessmen. But businessmen feel that these restrictions are unjustified. They take the maximum advantage of these provisions but do not like to part with the remaining part of by various clandestine devices; they convert it into black money and use it either for conspicuous production to satisfy the wants of the rich and elite sections of society.

(vii) ***Unscrupulous Charitable Trusts and Societies Create Tax Evasion:*** Unscrupulous charitable trusts and societies including religious institutions manipulate the funds of the institutions run and managed by them and create black money.

Example: A stark example of this has come to light when crores of rupees in hard cash and several more crores of rupees worth jewellery, diamonds and other valuables have been taken over when the personal chambers of the late Satya Sai Baba were opened recently at Puttaparthy in Andhra Pradesh. There are a lot of discussions going on in the matter whether the money found at Satya Sai Baba's Ashram at Puttaparthy is accounted or unaccounted money. Only sincere investigations undertaken by the government in this matter can find out the exact truth. This is one example which has come to light and many more are still likely to exist running this fraudulent business simply because such institutions had been exempted to submit the reports of their income and expenditure. It is feared that a lot of tax evasion is taking place at the religious, social and educational trusts throughout the length and breadth of the country.

(viii) ***Foreign Banks are Havens for Tax Evaders:*** Foreign banks especially the Swiss Banks which do not disclose the particulars of the account holders have become a safe haven for the people who want to hide their income without paying the taxes. There are different versions by different sources as to amount of the black money stashed in Swiss Banks.

Example: As alleged by Baba Ramdev during his agitations against black money, the amount of black money stashed in the Swiss banks ranges between ₹ 50–75 lakh crore of rupees.

(ix) ***Prohibited Trades:*** Important source of unaccounted money generates from illegal activities like large-scale smuggling of gold, diamond and numerous luxury products and drug trafficking leads to tax evasion.

3.3.3 Impact of Tax Evasion

The impacts of Tax Evasion are as follows:

(i) ***Country's Economic Growth:*** The biggest impact of tax evasion is that it halts the country GDP growth due to lack of funds from government. Government earning is depends upon the tax revenue. If the public will not pay the tax to government, Government cannot fund to particular sector which needs the funds for their better operation. Due to lack of funds government force to have taken loan from World Bank or other's countries, which will increases the burden of foreign debit on the government.

(ii) ***Increase the Inflation:*** The inflation rises while the black money circulates in the market. The price of eatable/others goods are increased to supply of that black money and less production of things in the market. So people which have that money they offer more price in the market. As compared from other person in the market. Higher inflation has affected middle and poor class families very badly. Since high amount of cash in limited hands has increased the purchasing power to that limited people and hence resulted in growth of market and prices.

The government taxes the people to earn revenue for its expenses in order to balance the budget. It is but natural that if the black money circulating in the economy is brought back to the government's treasury, the government will have more money in its hand for its expenses and thereby the tax burden on the people can be reduced.

(iii) ***Difficulty in the Formation of Monetary and Fiscal Policy:*** Since the government cannot take into account the black money in circulation in the economy while forming its monetary and fiscal policies, the policies so formed by the government cannot be realistic. It is difficult to form these policies in the absence of the exact calculation of the black money and without bringing it in the accounting procedures of the government.

(iv) ***Decreasing Rate of Investment in India:*** Since, the black money of Indian is mostly deposited outside India, resulting decreasing rate of investment in India. The expected amount of black money is supposed to end the unemployment problem of India in a few years if it is bring back to India.

(v) ***Tax Evasion Causes Decrease in Quality of Public Goods and Services:*** When bribes which are to paid as black money to the producers of goods and provider of services, it is but natural that they will provide the quality of goods and services only to the people who pay bribes whereas the general public has to suffer as the same quality and service is not provided to everyone.

Example: If you have to get a job done in office, your work will be done without any delay if you pay bribes to the officials who have to do your job. But for the same kind of job, another person who does not bribe the officials has to wait for several days, weeks or even months.

(vi) ***Rupee Depreciation:*** Tax evasion leads to flow of money out of country in terms of dollars by selling rupee, which leads to its depreciation. If tax is paid to the government it leads to the development of country which boosts overall growth of economy which in terms increases the rupee value.

(vii) ***Formation of Parallel Economy:*** The money generated through ill legal activities that are kept hidden from the concern government authorities. Taxes are not paid on that money. In opposite to this white money shown in accounts and tax paid on it. There is not transaction record of tax evaded money in the market. This is two different economy one is accountable and other is not accountable. Now a day's plenty of case of black money rises. The black money involved in illegal transaction accounts that it's between the ranges of 20% to 50% of country's growth. The effect of parallel economy is too much on Indian economy.

(viii) ***Impact on India's Reputation:*** This tax evasion and corruptions put a very bad impression of India's reputation. Many big businessmen in world are pulling their hand back from India. They are not interested in to do business with India due to this corruption. In Corruption Perceptions Index (CPI) India is ranked 87 numbers out of 178 countries. Due to big scams like 2G scam, common wealth game scam.

3.3.4 Remedies to Overcome (Reduce) Tax Evasion

The remedies to Overcome (Reduce) Tax Evasion are as follows:

(i) ***Reducing Tax Rate:*** Government by reducing the tax rate on an individual income & income earned after investment will encourage them to avoid tax evasion & invest in various investment instruments available in India itself, like DTC, tax deduction available in Provident fund, Post office schemes, etc.

(ii) ***Strong Surveillance System:*** Government should bring strong surveillance system in place which will check suspicious trade and transaction taking place and will have also have the complete authority to check tax defaulter, etc.

(iii) ***Simplified Tax Laws and Filling Mechanism:*** Present tax laws and tax filling mechanism is very complex and very difficult for a layman to understand it and claim for various deductions available in various sections. Simplified tax law will make things easy for everyone to pay taxes.

(iv) ***Disclosure of all Government Employees Assets:*** Disclosure of assets of government employee every year will somehow restrict them to indulge them in illegal activities and pay taxes on all income earned rightfully. This will also leads to overcome the loss of country resources and force other to do work completely and legally.

(v) ***Transparency in Government Expenditure:*** There should be transparency on government expenditure at every level to make sure the every rupee sent by government is reached at grass root level. This will avoid the vaporization of a large chunk of money done by higher-class official, politician, bureaucrats, contractors, etc. All offices of government should be brought under the audit of Comptroller and Auditor General of India (CAG). Bringing expenditures of ministry of defiance was one of the major such developments.

(vi) ***Issue of Special Bonds by the Government:*** Special bonds may be issued by the government asking the black money hoarders to invest in them by providing them immunity from criminal proceeding existing under the existing law.

(vii) ***Bringing Strong Corruption Laws:*** Corruption is the root cause of tax evasion; if corruption is reducing it will considerable reduce the tax evasion. And for reducing corruption and effective strong law like LOKPAL is needed, which can have the power to investigate every government employee and framing the maximum time for every case to make the final judgments unlike present which take years and still cannot punish them.

(viii) ***Ban & Surveillance on Illegal Trade & Practices:*** Trades like smuggling of commodities, drugs, baiting on cricket & various other activities like election polls, flesh trade are one of the major causes of tax evasion as this activities are illegal they are not viable to pay taxes on this and thus they evade taxes. Surveillance on these activities will reduce tax evasion and crime as well.

Self Assessment

State whether the following statements are true or false:

7. Tax evasion is not considered a crime.
8. It is not possible to understand the true impact of taxation without recognizing the existence of evasion.
9. Government earning is depends upon the tax revenue.

3.4 Tax Avoidance

Tax avoidance is the legal utilization of the tax regime to one's own advantage, in order to reduce the amount of tax that is payable by means that are within the law. Tax avoidance is a strategy which involves exploiting legal means of reducing taxes with the goal of minimizing tax liability. Avoidance is a perfectly legal approach to handling taxes, although sometimes avoidance practices can stray into the realm of being abusive, at which point people may cross the line into tax evasion. In tax evasion, people utilize illegal means to avoid paying all or part of their taxes; evasion can result in prosecution and fines or prison time.

Most taxpayers engage in a certain amount of tax avoidance, because people want to avoid paying more taxes than they need to. In a simple example, most people claim all of the exemptions available to them. Likewise, people may take advantage of retirement accounts which offer tax savings if they plan on saving money for retirement; as long as one is putting money aside, one might as well reduce taxes at the same time. These tax avoidance strategies are usually encouraged by financial planners and accountants.

Example: A skilled accountant can show a taxpayer where he or she can save on taxes, and provide advice about conducting financial affairs in a way which will limit tax liability. Accountants will usually not guarantee to reduce tax liability by a set amount or percentage, but they do pride themselves on finding as many ways as possible to generate tax savings for their clients.

Other tax avoidance strategies may be more aggressive. While still legal, they are sometimes deemed ethically questionable, and taxpayers may skirt the line between legality and illegality. Most accountants have personal limits when it comes to assisting people with tax avoidance, and while they will provide advice and help with fully legal activities, they may be reluctant to be involved in more gray areas. Aggressive tactics can include taking advantage of loopholes in the law which may be subject to interpretation, and not all accountants interpret these loopholes in the same way.

When people engage in tax avoidance, they are knowingly trying to reduce their taxes, but they are not knowingly breaking the law. Tax evaders, on the other hand, are aware of the fact that the means they are using are not legal, and they are choosing to engage in evasion activities despite this. Evasion tactics vary by nation, but include hiding or moving income so that it cannot be taxed even though it is legally taxable, or simply refusing to send in tax payments.

3.4.1 Double Taxation

Double taxation is the levying of tax by two or more jurisdictions on the same declared income (in the case of income taxes), asset (in the case of capital taxes), or financial transaction (in the case of sales taxes). This double liability is often mitigated by tax treaties between countries. Most countries impose taxes on income earned or gains realized within that country regardless of the country of residence of the person or firm. Most countries have entered into bilateral double taxation treaties with many other countries to avoid taxing non-residents twice — once where the income is earned and again in the country of residence. However, there are relatively few double-taxation treaties with countries regarded as tax havens. To avoid tax, it is usually not enough to simply move one’s assets to a tax haven. One must also personally move to a tax haven to avoid tax.

India has comprehensive Double Taxation Avoidance Agreements (DTAA) with 84 countries. This means that there are agreed rates of tax and jurisdiction on specified types of income arising in a country to a tax resident of another country. Under the Income Tax Act, 1961 of India, there are two provisions, Section 90 and Section 91, which provide specific relief to taxpayers to save them from double taxation. Section 90 is for taxpayers who have paid the tax to a country with which India has signed DTAA, while Section 91 provides relief to tax payers who have paid tax to a country with which India has not signed a DTAA. Thus, India gives relief to both kinds of taxpayers.

Did u know? **What is DTAA?**

This means that there are agreed rates of tax and jurisdiction on specified types of income arising in a country to a tax resident of another country.

Example: If a person earns ₹ 10,00,000 India, the income tax that will go to the Indian government will be ₹ 3,00,000, whereas the foreign government also will demand tax as per the prevailing laws. This, however, has caused a lot of problems to the income tax payers in the form of added taxation. Then, there's also the Double Tax Avoidance Agreement.

A large number of foreign institutional investors who trade on the Indian stock markets operate from Mauritius and the second being Singapore. According to the tax treaty between India and Mauritius, capital gains arising from the sale of shares are taxable in the country of residence of the shareholder and not in the country of residence of the company whose shares have been sold. Therefore, a company resident in Mauritius selling shares of an Indian company will not pay tax in India. Since there is no capital gains tax in Mauritius, the gain will escape tax altogether.

Did u know? The Indian and Cypriot tax treaty is the only other such Indian treaty to provide for the same beneficial treatment of capital gains.

Under the Income Tax Act, 1961 of India, there are two provisions, Section 90 and Section 91, which provide specific relief to taxpayers to save them from double taxation. Section 90 is for taxpayers who have paid the tax to a country with which India has signed DTAA, while Section 91 provides relief to taxpayers who have paid tax to a country with which India has not signed a DTAA. Thus, India gives relief to both kinds of taxpayers.

With DTAA, there are fixed TDS rates applicable for income in India. These rates vary from country to country. Countries such as UK (15%), USA (15%), UAE (12.5%), Germany (10%), China (10%), etc. have maintained good trade as well as income tax agreements with India. However, it is advisable for all NRIs to consult with a financial advisor before entering into any financial or investment-related agreement.

3.4.2 Differences between Tax Avoidance and Tax Evasion

Tax evasion and tax avoidance are both practices designed to reduce the amount people pay in taxes. The difference is that one involves legal means, while the other is illegal and is a form of tax fraud. Professionals such as attorneys and accountants who assist people with illegal means of reducing tax liability can be penalized along with the taxpayer.

In tax avoidance, people take advantage of the tax law to find ways to reduce their total tax liability. This is entirely legal and many people practice it every year at tax time. Using the services of a sharp tax attorney or tax accountant can save people significant amounts of money on their taxes. With tax avoidance, taxpayers seek out tax credits, write offs, and other means of cutting down on their tax liability.

The tax code is constantly being updated. Tax professionals keep up with changes to the law so that they can advise their clients on the best ways to reduce the amount of money they owe. With tax avoidance, people declare all of their income as required by law and submit other financial documents as needed, and the means used to reduce their tax liability are clearly documented on their tax returns.

With tax evasion, people avoid taxes not by scrupulously following the tax code, but by hiding or moving income, making false claims on a tax return, and utilizing other illegal means to pay less on their taxes. Some tax evaders avoid paying taxes altogether; people who work as independent contractors or receive monies under the table for their work, for example, may simply not declare this income and thereby avoid paying taxes on it.

The line between tax avoidance and tax evasion can sometimes be very fine. There are some things people can do with their money that are perfectly legal under the law, but could be read as attempts to evade taxes. Moving funds suspiciously and with no clear reason or documentation can attract the attention of tax authorities. Once tax authorities suspect someone of tax evasion, they will scrutinize that taxpayer closely.

Notable members of the criminal community, including no less a figure than infamous gangster Al Capone, have gotten in trouble for tax evasion. Sometimes, it is difficult to pinpoint illegal activity and prosecute people for activities such as Mob involvement, but those individuals can be thrown in jail for failing to pay taxes. In the eyes of the Internal Revenue Service, even income acquired from illegal activities needs to be declared and taxed.

Task List out some of the people who are involved in the Tax Evasion.

Self Assessment

Fill in the blanks:

10. …………………is a perfectly legal approach to handling taxes.
11. ………………………is the levying of tax by two or more jurisdictions on the same declared income, asset, or financial transaction.
12. With tax……………., people avoid taxes not by scrupulously following the tax code, but by hiding or moving income, making false claims on a tax return, and utilizing other illegal means to pay less on their taxes.

3.5 Tax Management

Tax management refers to the compliance with the statutory provisions. While tax planning is optional, tax management is of law. It includes maintenance of accounts, filling of return, payment of taxes, deduction of tax at source, timely payment of advance tax, etc. Poor tax management may lead to levy of interest, penalty, prosecution, etc. In some cases it may lead to heavy financial loss if proper compliance is not made.

Example: If a loss return is not filed in time it will result in a financial loss because such loss will not be allowed to be carried forward.

Tax Management includes maintenance of records in prescribed format. It also includes getting audited the records, filing returns and pay taxes. It is a regular feature of business enterprises and a form of tax planning. Here employees use CBDT (Central Board of Direct Taxes) and employers can use TDCAN (Tax Deduction and Collection Account Number).

3.5.1 Main Aims of Tax Management

The main aims of tax management are as follows:

(i) Compliance with legal formalities

(ii) Saving from penalties and prosecution

(iii) Taking advantage of various tax incentives and deductions

(iv) Review of department orders

3.5.2 Areas of Tax Management

The main areas of tax management are as follows:

1. Deduction of tax at source can be done with respect of income from salaries, winning from lottery, horse race etc.
   - Employer seeks for TDCAN and employee for Pan Card.
   - TDS should be deposited in government treasury.
   - Employer should furnish to the employee a certificate regarding TDS.
   - Employer should furnish quarterly and annual returns regarding TDS.
2. Payment of Tax on the basis of following:
   - Advance payment of tax.
   - Tax on Self Assessment
   - Payment on Demand
3. Audit of Accounts on the basis of the following:
   - If business income exceeds 40 lakhs.
   - If business income exceeds 10 lakhs.
4. Fulfilment of conditions to claim deductions.
5. Furnishing return of income.
6. Documentation and maintenance of records.
7. Review of Orders.

3.5.3 Differences between Tax Planning and Tax Management

While tax planning and tax management correlate with each other, the two aspects of taxes have several differences. The primary difference between tax planning and tax management is the time frame in which each part is conducted. The tax planning takes place ahead of time, while the tax management is the implementation of the plan.

The first primary difference between tax planning and tax management is the requirements. While tax planning is not a requirement for either a business or individual, tax management is a requirement. Every individual and business in the United States is required to manage taxes, which includes filing the appropriate state and federal tax returns.

The second primary difference between tax planning and tax management is about tax liability. When a business or individual goes through the tax planning process, they are trying to minimize the tax liability of the entity by planning deductions, purchases and expenses ahead of time. Tax management, however, involves making sure that when the tax plan is implemented, that it is according to the tax laws and regulations.

The third difference between tax planning and tax management pertains to liabilities. Tax planning involves taking the actions necessary to minimize the tax liabilities of the business or the individuals. Tax management on the other hand is about avoiding the payment of interest or fees for not abiding by the tax laws and regulations.

The fourth difference between tax planning and tax management is the time frame. Tax planning is an action that is taken in the present but relates to the future. Tax management, on the other hand, encompasses the past, present and future. This includes tracking past sales, deductions, assets and more, making current tax payments and preparing tax documents for any future payments that must be made.

While there are plenty of differences between tax planning and tax management, there is also one primary similarity. The primary similarity between tax planning and tax management is that tax planning is a subset, or a part, of tax management. When an individual or business is in the process of tax planning, they are also taking into account all of the aspects of tax management, including tax deductions, proper auditing of the accounting files and records, putting together and filing the tax return documents on time and planning for tax scenarios that may come up during that particular tax year.

Self Assessment

State whether the following statements are true or false:

13. Poor tax management may lead to levy of interest, penalty, prosecution, etc. In some cases it may lead to heavy financial loss if proper compliance is not made.
14. Tax planning is a requirement for either a business or individual.
15. Tax management on the other hand is about avoiding the payment of interest or fees for not abiding by the tax laws and regulations.

Case Study

Tax Avoidance or Tax Evasion

En. Khir, the company accountant, was deep in thought in his office. His friend, Ravi, who was passing by Khir's office, saw him through the glass window. On seeing his worried look, Ravi knocked and entered.

"What is haunting you? Immersed so deeply in something? What is in your mind," Ravi asked.

Khir replied, "Our human resources manager is recruiting some software employees from India and has assigned me the job of recommending the most tax efficient remuneration package equivalent to RM 200,000 per annum. To attract expatriates, the manager feels that they should pay lower income tax as compared to others earning the same level of income."

"How is it possible for us to pay lesser income tax for the same level of income? Is it not tax evasion?" Ravi asked. He cautioned Khir that tax evasion was illegal and both employees and the organisation would be penalised for this by the Government for violating the income tax laws. Moreover, tax evasion was unethical and also a crime against society.

Khir explained, "Ravi, yes, tax evasion is illegal and punishable. But tax avoidance is not punishable. In fact, tax law encourages assessors to plan their taxes and pay lesser tax by properly applying the relevant sections of the Income Tax Act."

"Is it so? It is interesting. Could you please elaborate? I am also an expatriate employee and I want to know more about this," Ravi replied.

Khir continued, "I think our employees especially those who draw more than RM100,000 per annum should be advised on this tax avoidance and tax planning techniques because

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Notes

their income will be taxed at the maximum marginal tax rate which is 26% in 2010. If they apply tax avoidance techniques, they can save RM260 in taxes for every RM1,000 income avoided which is a substantial sum." "Please give some simple examples so that I can understand all these tax jargons," Ravi requested. "Sure, employees who draw higher salaries should not go for allowances. Take for instance, the House Rent Allowance (HRA) and Travelling Allowance (TA), these allowances are fully subjected to tax. Instead, if an employee opts for a Rent-Free Accommodation (RFA) provided by the employer the tax bill will be reduced. Similarly, the Travelling Allowance may be replaced by providing car, fuel and driver to these employees. The car can be used by the employees for private purposes also," Khir added.

"In what way will this save tax? Both are taxable at the same rates," Ravi insisted.

Khir gave an explanation on how different allowances were treated in the Income Tax Act. "The HRA is fully taxable whereas for RFA there is a formula to convert this non-cash item into cash equivalent. That formula produces a lesser value for the accommodation provided and this in turn will reduce taxable income. Similarly, instead of travelling allowance, one can opt for a car, fuel and driver from the employer. For the car, fuel and driver, there is also a formula that will produce lesser taxable value and the taxable income will be considerably reduced, especially for expatriates who are hesitant to buy cars as the disposal value of the used cars is generally very low. Most times, there is no market for used car in Malaysia. Another allowance that plays a significant role in tax planning is entertainment allowance. Entertainment allowance will be fully added in Section 13.1(a) and the expenditure incurred for official purposes will be given as a deduction. But the problem is the RFA value is calculated with the gross entertainment allowance and not with the net allowance."

Tax Planning

"Then what is this tax planning about?" Ravi asked.

"One of the approaches is to invest our savings in Income Tax Act - approved schemes so as to get approved reliefs and thus our chargeable income will be less and then subjected to lesser tax payable," Khir replied.

"It is interesting. Could you please give more examples for this?" Ravi requested. Khir then gave to Ravi the following list of individual tax reliefs.

No.	Individual Relief Types	Amount (RM)
1	Education Fees (self)	5,000 (Limited)
2	Complete medical examination (self)	500 (Limited)
3	Purchase of books, journals and magazines (not newspapers)	1,000 (Limited)
4	Purchase of personal computer (once in every 3 years)	3,000 (Limited)
5	Saving in SSPN's scheme	3,000 (Limited)
6	Purchase of sport equipment for sport activities (approved)	300 (Limited)
7	Life insurance and EPF contributions by employee	6,000 (Limited)
8	Insurance premium for education or medical benefit	3,000 (Limited)

Ravi had a look at the list and immediately responded, "I cannot understand any of the examples given. Rather than telling me and giving me this list, can you please come up with some hypothetical income levels with HRA or RFA, CAR or TA etc. to illustrate how much tax reduction one can get by applying different levels of salaries and remuneration schemes? The illustrations you have prepared will not only be useful for expatriates but also for all employees.

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We can advise our employees on these useful matters. They will be happy. We also can convince and educate them that tax evasion is unethical but tax avoidance and tax planning are acceptable. Please illustrate with figures for all the above tax jargons."

"Sure, but give me at least one week to come up with all details because I have to update myself with the latest tax enactments," Khir replied.

The following week Ravi received a call from Khir. He confirmed that he had prepared ten different salary schemes with the same gross total income of RM 200,000, but with different allowances, perquisites (PER) and benefits-in-kind (BIK).

He explained to Ravi that employees could get paid by employers in different forms and how these payments were taxed under the Income Tax Act. He provided the following table which provided all relevant details in matrix form.

	E1	E2	E3	E4	E5	E6	E7	E8	E9	E10
	Only salary	Sal + EPF	RFA	HRA	TA RFA	TA HRA	RFA CAR BIK	HRA CAR BIK	RFA CAR PER	HRA CAR PER
Salary	190000	154000	106000	106000	82000	82000	76000	76000	76000	76000
Entertainment allowance	10000	10000	10000	10000	10000	10000	10000	10000	10000	10000
Employer EPF		36000	36000	36000	36000	36000	36000	36000	36000	36000
Fair rent / HRA 3000			48000	48000	48000	48000	48000	48000	48000	48000
Travelling Allowance / Value of car RM 130,000					24000	24000	10000	10000	10000	10000
Fuel							6000	6000	6000	6000
Driver							12000	12000	12000	12000
Notebook given by employer							2000	2000	2000	2000
Gross Package	**200000**	**200000**	**200000**	**200000**	**200000**	**200000**	**200000**	**200000**	**200000**	**200000**
Official Entertainment expenses	10000	10000	10000	10000	10000	10000	10000	10000	10000	10000
Donations to Govt	1000	1000	1000	1000	1000	1000	1000	1000	1000	1000
Notebook Purchased	2000	2000	2000	2000	2000	2000	0	0	0	0
Employee PF contribution	4000	4000	4000	4000	4000	4000	4000	4000	4000	4000

Assumptions given:

1. All employees receive the same gross income of RM200,000. The payment method is different. The savings remain the same. For instance, all employees save:
   (a) RM4,000 in EPF payment,
   (b) RM2,000 for purchase of one notebook (computer),
   (c) RM1,000 for donations to the Government, and
   (d) All employees claim that the entertainment allowance (EA) was fully spent on entertaining company's clients.
2. Employee 1 (E1) gets his gross salary in two forms: RM190,000 as salary and RM 10,000 as EA.
3. Employee 2 (E2) gets RM154,000 as salary, RM10,000 EA and requests that his employer contribute to his approved provident fund account the sum of RM3,000 monthly.
4. Employee 3 (E3) receives RM 118,000, RM10,000 and RM36,000 as salary, EA and rent free accommodation (RFA) and also requests his employer to contribute to his approved provident fund account the sum of RM3,000 monthly.
5. Employee 4 (E4) receives house rent allowance (HRA) instead of RFA for the same value as employee 3.
6. Employee five (E5) gets the same allowances as E4 but RFA and his salary is further reduced as he gets travelling allowance (TA) of RM 24,000 for private purposes.
7. Employee six (E6) gets the same allowances as E5 but gets HRA instead RFA.
8. Employee 7 (E7) receives RFA and a car valued RM130,000 (company charges RM 10,000 pa for the car), fuel and driver for RM28,000 instead of travelling allowance.

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9. Employee 8 (E8) receives HRA instead of RFA and the same emoluments as E7.
10. Employee 9 (E9) receives RFA and reimbursement of his personal car expenses, fuel and driver valued at RM28,000.
11. Employee 10 (E10) receives HRA instead of RFA and the same emoluments as E9.

The Assignment

Ravi was really confused with the above data and was not sure whether there could be any tax savings. He requested that Khir to give a more detailed calculations and explanations on the relevant income tax sections that allowed those deductions and reliefs. Ravi wanted to know the ultimate tax payable by each employee for the year of assessment 2010.

Tax Rates for YA 2010

Slabs	Chargeable Income (RM)	Slabs (RM)	Rate %	Tax(RM)	Cumulative Tax (RM)
1	0-2500	On the First 2,500	0	0	0
2	2,501-5,000	Next 2,500	1	25	25
3	5,001-20,000	Next 15,000	3	450	475
4	20,001-35,000	Next 15,000	7	1050	1525
5	35,001-50,000	Next 15,000	12	1800	3325
6	50,001-70,000	Next 20,000	19	3800	7125
7	70,001-100,000	Next 30,000	24	7200	14325
8	Above 100,000		26	?	?

Questions

1. Comment on the differences in benefits to the employees.
2. What are the learning points from the case study?

Source: http://ejournal.unirazak.edu.my/articles/TAX_AVOIDANCE-Ravindran.pdf

3.6 Summary

- Tax planning is not a device to reduce tax burden but is in fact helps savings by investments in government securities.
- Tax planning is an essential part of your financial planning.
- There are also some areas of tax planning that are specific to certain business forms—i.e., sole proprietorships, partnerships, C corporations, and S corporations.
- Tax planning also applies to various types of employee benefits that can provide a business with tax deductions, such as contributions to life insurance, health insurance, or retirement plans.
- Tax Planning India is an application to reduce tax liability through the finest use of all accessible allowances, exclusions, deductions, exemptions, etc., to trim down income and/ or capital profits.
- Corporate Tax Planning is the strategies to reduce the taxes.
- Tax evasion is the general term for efforts by individuals, firms, trusts and other entities to evade taxes by illegal means.
- Tax avoidance is a strategy which involves exploiting legal means of reducing taxes with the goal of minimizing tax liability.
- Double taxation is the levying of tax by two or more jurisdictions on the same declared income (in the case of income taxes), asset (in the case of capital taxes), or financial transaction (in the case of sales taxes).

- Tax management refers to the compliance with the statutory provisions and includes maintenance of records in prescribed format.

3.7 Keywords

Accounting Methods: Accounting methods refer to the basic rules and guidelines under which businesses keep their financial records and prepare their financial reports.

Corporate Tax: It refers to a tax levied by various jurisdictions on the profits made by companies or associations.

Double Taxation: It is the levying of tax by two or more jurisdictions on the same declared income (in the case of income taxes), asset (in the case of capital taxes), or financial transaction (in the case of sales taxes).

Partnerships: A business organization in which two or more individuals manage and operate the business.

Sole Proprietorships: A business structure in which an individual and his/her company are considered a single entity for tax and liability purposes.

Tax Avoidance: It is the legal utilization of the tax regime to one's own advantage, in order to reduce the amount of tax that is payable by means that are within the law.

Tax Evasion: It is the general term for efforts by individuals, firms, trusts and other entities to evade taxes by illegal means.

Tax Management: It refers to the compliance with the statutory provisions.

Tax Planning: Tax planning is a broad term that is used to describe the processes utilized by individuals and businesses to pay the taxes due to local, state, and federal tax agencies.

Tax Rebates: A tax rebate may be a partial sum of money refunded to people from paid taxes, or it may be an amount by which you reduce your taxes before you pay them.

Tax Savings: The deduction a taxpayer can take on their tax form for interest paid on a home mortgage.

3.8 Review Questions

1. Define Tax Planning. List out the general areas of tax planning.
2. "Tax planning is an essential part of your financial planning. "Elucidate.
3. Write short notes on the following:
   (a) C corporations
   (b) Sole Proprietorships and Partnerships
   (c) Case for Levy of Corporate Tax
   (d) Double taxation
4. Describe some of the planning tips that can assist salaried people to reduce their tax accountability.
5. What is Corporate Tax Planning?
6. Discuss the causes of Tax evasion.

7. Highlight the impacts of Tax Evasion.
8. Differentiate the following:
   (a) Tax Avoidance and Tax Evasion
   (b) Tax Planning and Tax Management
9. What are the objectives of Tax Management?
10. Explain the remedies to Overcome (Reduce) Tax Evasion.

Answers: Self Assessment

1.	False	2.	True
3.	False	4.	Corporate Tax
5.	Minimise	6.	Liquidity
7.	False	8.	True
9.	True	10.	Avoidance
11.	Double taxation	12.	Evasion
13.	True	14.	False
15.	True		

3.9 Further Readings

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http://www.answers.com/topic/tax-planning-in-accounting

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http://www.slideshare.net/anujbhatia09/corporate-tax-planning

Unit 4: Exemptions and Deductions – I

CONTENTS

Objectives

After studying this unit, you will be able to:

- Define agricultural income and its tax treatment
- Discuss the important Exemption in Income Tax Act
- Describe the tax exemptions for charitable trusts and institutions
- List down the Income not to be included in the Total Income
- Elucidate the tax treatment for Income from Voluntary Contributions
- Trace the Income to be included in Total Income
- Explain the Tax exemptions to political parties

Introduction

Various tax systems grant a tax exemption and tax deductions to certain organizations, persons, income, property or other items taxable under the system. Tax exemption refers to a personal allowance or specific monetary exemption which may be claimed by an individual to reduce taxable income under some systems. Tax exempt status may provide a potential taxpayer complete relief from tax, tax at a reduced rate, or tax on only a portion of the items subject to tax.

On the other hand, a tax deduction is a reduction of a taxpayer's total income that decreases the amount of money used in calculating the tax due. Essentially, it's a break granted by the government that reduces taxes by a percentage that is dependent upon the income bracket of the taxpayer.

Tax is calculated on the income earned in the previous year. For providing relief to the tax payers from payment of tax, income tax law provisions contains concept of exemption and deduction. Exempted income means the income which does not at all charged to any taxes, while calculating the Gross Total Income.

Under Section 10 of the Income Tax Act, various items of income are totally exempt from income-tax. Therefore, these incomes are not included in the total income of an assessee. Section 10 provides that in computing the total income of a previous year of any person, any income falls in its ambit shall not be included in the total income, provided the assessee proves that a particular item of income is exempt and falls within a particular clause. The onus is on the assessee i.e. the assessee has to prove that his income falls under Section 10.

After going through this unit, you will learn the income which does not form part of the total income, the conditions to be satisfied for availing exemption under Section 10.

4.1 Agricultural Income

Agricultural income as defined in Section 2(1A) is exempt from income tax in the case of all assesses. This exemption has been granted on account of the constitutional provisions relating to the powers of the Central and the State Governments for levying tax on agricultural income.

Agriculture income is exempt under the Indian Income Tax Act. This means that income earned from agricultural operations is not taxed. The reason for exemption of agriculture income from Central Taxation is that the Constitution gives exclusive power to make laws with respect to taxes on agricultural income to the State Legislature. However while computing tax on non-agricultural income agricultural income is also taken into consideration.

As per section 2(1A) of the Act, agricultural income means any income which includes the following:

1. ***Rent received from the land used for agricultural purposes:*** When a person (landlord or tenant) lets out a piece of land, which is situated in India, for agricultural purposes, the rent received either in cash or kind from the tenant is considered as agricultural income.

2. ***Revenue income derived from agriculture:*** When the landlord or tenant cultivates the farm, raises the product and sells it or appropriates it for his individual needs, the difference between the cost and selling price (including the value of self consumption on the basis of average market rate for the year) is the income derived from agriculture.

3. ***Income from making the produce fit to be taken to market:*** The crop as a harvested might not find a market. If, in order to make the product a saleable commodity, the cultivator or receiver of rent-in-kind performs some operation (manual or mechanical) and enhances the value of the produce, the enhancement of value of the produce is also agriculture income. Such income to be regarded as agricultural income, the following conditions must be satisfied:

    - The operation must be one which is ordinarily employed by the cultivator to make the produce fit for market, i.e., threshing, winnowing, cleaning, drying, etc.

    - There is no market (ready and willing and not a theoretical market) for the produce as received from the farm.

- The process to make it marketable has been performed either by the cultivator or receiver of rent-in-kind.
- The produce must not change its original character.

Example: Where a farmer grew mulberry leaves and fed the same to silk-worm, it was not a process employed by the cultivator of mulberry leaves to make them marketable by way of producing silk cocoons, and the income derived from rearing of silk-worms was not agricultural income because the silk cocoons produced by silk-worms did not bear any character of an agricultural produce or as a marketable form of mulberry leaves.

4. ***Income from sale of produce:*** When the cultivator or receiver of rent-in-kind sells the produce either after performing certain activities to make it fit for market or without doing any such activity, the income is agricultural income. It is immaterial that he has sold the produce to the wholesaler in the market or through his own retail shop directly to the consumers.

5. ***Income from building:*** In the following cases the income from building or house property is treated as agricultural income:

   - If the landlord receives rent in cash, it is owned and occupied by him; or if the landlord receives rent-in-kind, it is occupied by him – whether owned or not; or if it is occupied by the cultivator – whether owned by him or not;
   - If it is on or in the immediate vicinity of the agricultural land;
   - If it is required as a dwelling-house or as a store house or as an out-house by the landlord or cultivator;
   - If it is required by reason of the landlords or cultivators connection with the land, i.e., either the building is required to make the produce fit to be taken to the market or there is a sufficient quantity of produce which requires a store house or there are numerous tenants and it is necessary to stay there to collect the rent or it is necessary for the cultivator to be there to look after the farm.
   - The land is assessed to land revenue in India; or the land is subject to land revenue or local rate assessed and collected by the officers of the Government – either Central or State for the benefit of local bodies. Where the land is not so assessed, the building should not be situated:
     - in an area of municipality (whether known as Municipal Corporation, Notified Area Committee, Town Area Committee, or by any other name or Cantonment Board) whose population according to the latest census figures published is 10,000 or more; or
     - in a notified area within such limits of a Municipality, etc., as may be notified by Government.

However, the distance of notified area cannot exceed 8 kilometres from the local limits. The department has issued various circulars from time to time specifying the notified areas.

Notes Certain income which is not treated as Agricultural Income includes:

1. Income from poultry farming.
2. Income from bee hiving.

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3. Income from sale of spontaneously grown trees.
4. Income from dairy farming.
5. Purchase of standing crop.
6. Dividend paid by a company out of its agriculture income.
7. Income of salt produced by flooding the land with sea water.
8. Royalty income from mines.
9. Income from butter and cheese making.
10. Receipts from TV serial shooting in farm house are not agriculture income.

4.1.1 Conditions to be Satisfied for Agricultural Income

According to the definition of Agricultural Income as per Section 2(1A) of the Act, the income which satisfies following conditions is treated as agricultural income.

1. ***Rent or revenue derived from land:*** For any income to be considered as agricultural income, the rent or revenue should be derived from land. Following things need to be kept in mind:
   - The word rent denotes the payment of money either in cash or in kind by one person to another (owner of the land) in respect of grant of right to use land.
   - The recipient of rent or revenue should be the owner of the land.
   - The expression revenue is used in the broader sense of return, yield or income, and not in the sense of land revenue.
   - Income is said to be derived from land only if the land is the immediate and effective source of the income and not the secondary and indirect source. Thus interest on arrears of rent payable in respect of agricultural land is not agricultural income because the source of income (interest) is not from land but it is from rent which is a secondary source of income and is taxable under the head Income from other sources.
2. ***Land must be situated in India:*** Land must be situated in India but it is immaterial whether the agricultural land in question has been assessed to land revenue or local taxes assessed and collected by the Officers of the Government in India.
3. ***Land must be used for agricultural purpose*:** The land must be used for agricultural purposes. There must be some measure of cultivation on the land, some expenditure of skill and labour upon it, to have been used for agricultural purposes within the meaning of the Act. The operations on the land for agricultural purposes can be:
   - *Basic operation:* These include tilling of the land, sowing of seeds, planting or an operation of a similar kind such as digging pits in the soil to plant a sapling etc.
   - *Subsequent operations:* These include weeding, digging the soil around the growth, nursing, pruning, cutting, etc.

Caution Please note that here agriculture connotes all the products of vegetable kingdom (food for human beings and animals, fruits, commercial crops, flowers, medicines, bamboo, timber, fuel material) but it does not include the products of animal kingdom (dairy farming, butter and cheese making, poultry farming, breeding of livestock etc.).

4.1.2 Partly Agricultural Income

As per Rule 7 of the Income Tax Rules, 1962 – In the case of income which is partially agricultural income as defined in section 2 and partially income chargeable to income-tax under the head "Profits and gains of business", in determining that part which is chargeable to income-tax the market value of any agricultural produce which has been raised by the assessee or received by him as rent-in-kind and which has been utilized as a raw material in such business or the sale receipts of which are included in the accounts of the business shall be deducted, and no further deduction shall be made in respect of any expenditure incurred by the assessee as a cultivator or receiver of rent-in-kind. For this purpose "market value" shall be deemed to be:

1. where agricultural produce is ordinarily sold in the market in its raw state, or after application to it of any process ordinarily employed by a cultivator or receiver of rent-in-kind to render it fit to be taken to market, the value calculated according to the average price at which it has been so sold during the relevant previous year;
2. where agricultural produce is not ordinarily sold in the market in its raw state or after application to it of any process aforesaid, the aggregate of –
   (a) the expenses of cultivation;
   (b) the land revenue or rent paid for the area in which it was grown; and
   (c) such amount as the Assessing Officer finds, having regard to all the circumstances in each case, to represent a reasonable profit.

Example: If a cotton mill has its own farm and the cotton grown on the farm has been utilized in the factory, the average market price of the cotton shall be deducted from the sale proceeds of cotton while computing the taxable income from business.

Self Assessment

Fill in the blanks:

1. Agriculture income is ……………………..under the Indian Income Tax Act.
2. For any income to be considered as agricultural income, the rent or revenue should be derived from ……………………
3. ……………………..denotes the payment of money either in cash or in kind by one person to another in respect of grant of right to use land.
4. ………………….include tilling of the land, sowing of seeds, planting or an operation of a similar kind such as digging pits in the soil to plant a sapling etc. in agricultural income.

4.2 Other Important Exemptions

In addition to the exemption of tax on agricultural income in India the following exemptions are also available under the Section 10 of Income Tax Act:

1. ***Money received by an individual as a member of H.U.F [Section 10(2)]:*** Any sum received by an individual in his capacity as a member of H.U.F. is wholly exempt from income-tax where such sum has been paid out of the income of the family, or out of the income of an impartible estate belonging to the family, because that has been taxed in hand of H.U.F.

Did u know? This exemption is, however, subject to the provisions of Section 64(2), where the income from self acquired assets which are converted into property of the H.U.F. are to be clubbed with the income of the person who makes the conversion subject to certain conditions. For the purpose of this exemption, it is immaterial whether the H.U.F. has been subject to tax in respect of the income. It is also immaterial whether the member who has received the share of income from the family is a coparcener or not but he must be a member of that family at the time of receiving the money.

2. ***Share of profit from partnership firm [Section 10(2a)]:*** Share income of a person being a partner of a firm (including Limited Liability Partnerships) which is separately assessed as such is exempt from tax. For the purposes of this clause, the share of a partner in the total income of a firm separately assessed as such shall be an amount which bears to the total income of the firm the same proportion as the amount of his share in the profits of the firm in accordance with the partnership deed bears to such profits.

3. ***Interest income of non-residents [Section 10(4)]:*** In the case of non-residents any income from interest on such securities or bonds as the Central Government may by notification in the Official Gazette specify in this behalf including income by way of premium on the redemption of such bonds. However in the case of an individual, any income by way of interest on moneys standing to his credit in a Non-resident (External) Account in any bank in India in accordance with the Foreign Exchange Regulation Act, 1973 and the Rules made thereunder.

4. ***Interest income of non-residents from specified savings certificates [Section 10(4b)]:*** In the case of an individual being a citizen of India or a person of Indian origin, who is a non-resident, any income from interest on notified savings certificates issued before the 1st day of June, 2002 by the Central Government will be exempt provided he subscribes to such certificates in foreign currency or other foreign exchange remitted from a country outside India in accordance with the provisions of the Foreign Exchange Management Act, 1999 and any rules made thereunder. It is important to note that the exemption will be available only to the original subscribers to the savings certificates.

5. ***Leave travel concession [Section 10(5)]:*** As per section 10(5), the amount exempt under section 10(5) is the value of any travel concession or assistance received or due to the assessee from his employer for himself and his family in connection with his proceeding on leave to any place in India. The amount exempt can in no case exceed the expenditure actually incurred for the purposes of such travel. Only two journeys in a block of four years are exempt. Exemption is available in respect of travel fare only and also with respect to the shortest route.

6. ***Tax paid on behalf of foreign companies in respect of certain income [Section 10(6a)]:*** Under clause (6A), where income is derived by a foreign company by way of royalty or fees for technical services received from government or an Indian concern in pursuance of an agreement made by the foreign company with government or Indian concern after March 31, 1976 which is approved by the Central Government or where the agreement relates to matter included in the industrial policy of the government for the time being in force and tax on such income is payable, under the terms of such agreement by the government or the Indian concern to the Central Government, the tax so paid will not be included in computing the total income of the foreign company. This exemption is not available under Section 10(6A) if the agreement is entered into on or after 1.6.2002, as amended by Finance Act, 2002. In other words, the exemption is available for the agreements entered into up to 31.5.2002 only.

7. ***Income derived by a foreign company [Section 10(6b)]:*** Clause (6B) provides that where in the case of non-resident (other than a company) or of a foreign company deriving income (other than salary, royalty or fees for technical services) from Government or an Indian concern in pursuance of an agreement entered into by the Central Government with the Government of a foreign State or an international organisation, the tax on such income is payable by Government or the Indian concern to the Central Government under the terms of that agreement or any other related agreement approved by the Central Government, the tax so paid shall be exempt. Finance Act, 2002 has provided that this exemption is not available under Section 10(6A) if the agreement is entered into on or after 1.6.2002. In other words, the exemption is available for the agreements entered into upto 31.5.2002 only.

8. ***Fees for technical services received by foreign companies [Section 10(6c)]:*** Clause (6C) grants exemption to any income arising to the foreign companies notified by the Central Government by way of royalty or fees for technical services received pursuant to an agreement entered into with that Government for providing services in or outside India in projects connected with security of India.

9. ***Foreign allowance [Section 10(7)]:*** Allowances or perquisites paid or allowed as such outside India by the Central Government to a citizen of India for his services rendered outside India, would be wholly exempt from income-tax.

10. ***Co-operative technical assistance programmes [Section 10(8)]:*** In the case of an individual who is assigned duties in India in connection with co-operative technical assistance programmes and projects in accordance with an agreement entered into by the Central Government with the Government of a foreign State, the terms of which provide for the exemption from tax, the remuneration received by the individual directly or indirectly from the Government of that foreign State for such duties and any other income of such individual which accrues or arises outside India (but is not deemed to accrue or arise in India) and in respect of which such individual is required to pay any income- tax or social security tax to the Government of that foreign State, would be exempt from income-tax.

11. ***Income of any member of the family [Section 10(9)]:*** The income of any member of the family of any such individual referred to in the preceding Clauses 8, 8A & 8B of Section 10, accompanying him to India which accrues or arises outside India and is not deemed to accrue or arise in India, is also exempt from tax provided that the member is required to pay any income-tax or social security tax to the Government of that foreign State on such income or as the case may be to the country of origin of such member.

12. ***Death-cum-retirement gratuity [section 10(10)]:*** The amount of any death-cum-retirement gratuity received under:

    - the revised pension rules of the Central Government; or
    - the Central Civil Services (Pension) Rules, 1972; or
    - any similar scheme applicable to (a), the members of civil services of the Union, or (b) holders of posts connected with defence or of civil posts under the Union, or (c) the member of All India Services, or (d) the members of civil services of a State, or (e) holders of civil posts under a State, or (f) employees of a local authority, or (g) Pension Code or Regulations applicable to the members of the defence services is wholly exempt from tax under Section 10(10)(i) of the Act.

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Notes The payment of gratuity by the Life Insurance Corporation of India under the Staff Regulations is wholly exempt from tax under Section 10(10), as the object and purpose of the gratuity scheme of the Life Insurance Corporation of India and the Revised Pension Rules of the Central Government are the same.

13. ***Retrenchment compensation [section 10(10b)]:*** Any compensation received by a workman under the Industrial Disputes Act, 1947 or under any other Act or rules, orders or notifications issued thereunder or under any standing orders or under any award, contract of service or otherwise, at the time of his retrenchment. The amount is exempt under this clause to the extent of least of the following limits:

    (a) Actual amount received.

    (b) Amount specified by Central Government i.e. ₹ 5,00,000.

    (c) An amount calculated in accordance with the provisions of clause (b) of Section 25F of the Industrial Disputes Act, 1947 i.e. 15 day's average pay for every completed years of services or part thereof in excess of 6 months.

Caution It may be noted that the above provision shall not apply in respect of any compensation received by a workman in accordance with any scheme which the Central Government may, having regard to the need for extending special protection to the workmen in the undertaking to which such scheme applies and, other relevant circumstances, approve in this behalf and the entire amount of compensation so received shall be exempt.

Did u know? Where retrenchment compensation received by a workman exceeds the amount which qualifies for exemption under the new clause, he will be entitled to relief under section 89 read with rule 21A of the Income Tax Rules, in respect of such excess.

14. ***Compensation received by victims of Bhopal gas leak disaster [Section 10(10bb)]:*** According to the clause any compensation received by victims of Bhopal Gas Leak Disaster under the Bhopal Gas Leak Disaster (Processing of Claims) Act, 1985 and any scheme framed thereunder is exempt from tax. This exemption of compensation received, however, would not be available to any assessee in connection with the Bhopal Gas Leak Disaster of an expenditure which has been incurred and allowed as a deduction from taxable income.

15. ***Payment received on voluntary retirement [section 10(10c)]:*** The amended provision provides for exemption of any amount received or receivable by an employee of a public sector company or of any other company or an authority established under Central, State or Provincial Act or a local authority, or any State Government or Central Government or the Institution having importance throughout India or a recognised management institute, on his voluntary retirement or termination of his service, in accordance with any scheme or schemes of voluntary retirement or in the case of a public sector company, a scheme of voluntary separation. The scheme of voluntary retirement is to be framed in accordance with such guidelines as may be prescribed which may include among other things the criteria of economic viability. The amount of exemption is the actual amount of compensation or ₹ 5,00,000, whichever is less. This exemption is available only once in the life time of an assessee.

Caution The assessee shall not be eligible for relief under section 89 in case he has claimed exemption under section 10(10C). On the other hand, if he claims relief under section 89, he cannot claim exemption under section 10(10C)

16. ***Tax on perquisite paid by employer [Section 10(CC)]:*** As per section 10(CC), the amount of tax actually paid by an employer, at his option, on non-monetary perquisites on behalf of an employee, is not taxable in the hands of the employee. Such tax paid by the employer shall not be treated as an allowable expenditure in the hands of the employer under section 40.

17. ***Amount paid on life insurance policies [Section 10(10D)]:*** As per section 10(10D), any sum received on life insurance policy (including bonus) is not chargeable to tax. Exemption is, however, not available in respect of the amount received on the following policies:

    a. any sum received under section 80DD (3) or 80DDA (3);

    b. any sum received under a Keyman insurance policy;

    c. any sum received under an insurance policy (issued after March 31, 2003) in respect of which the premium payable for any of the years during the term of policy exceeds 20 per cent of the actual sum assured.

Did u know? "Keyman insurance policy" means a life insurance policy taken by a person on the life of another person who is or was the employee of the first-mentioned person or is or was connected in any manner whatsoever with the business of the first-mentioned person.

In respect of (c) above, the following points should be noted:

- Any sum received under such policy on the death of a person shall continue to be exempt.
- The value of any premiums agreed to be returned or of any benefit by way of bonus or otherwise, over and above the sum actually assured, which is received under the policy by any person, shall not be taken into account for the purpose of calculating the actual capital sum assured under this clause.

18. ***Payment from statutory provident fund [section 10(11)]:*** Any payment received from a provident fund to which the Provident Funds Act, 1925 applies or any other provident fund set-up by the Central Government and notified by it in the Official Gazette, would be exempt from tax without any monetary or other limits.

Notes Any payment received from a provident fund to which the Provident Funds Act, 1925 applies is known as Statutory Provident Fund and the provident fund set-up by the Central Government and notified by it in the Official Gazette is known as Public Provident Fund.

19. ***Payment from a recognised provident fund [section 10(12)]:*** The accumulated balance due and becoming payable to an employee participating in a recognised provident fund, would be exempt from tax if the following conditions are satisfied:

(a) The employee has rendered continuous service with his employer for a period of 5 years or more; or

(b) Where he has not rendered such continuous service, the service has been terminated by reason of employee's ill-health or by the contraction or discontinuance of the employer's business or by any other cause beyond the control of the employee; or

(c) On cessation of his employment he obtains employment with any other employer and the balance standing in his Recognised Provident Fund is transferred to his account in a Recognised Provident Fund maintained by the new employer.

Where the accumulated balance of the fund has been transferred to any other such fund, then in computing the period of continuous service for clause (i) or clause (ii) the period or periods for which such employee rendered continuous service under his former employer or employers shall be included.

20. ***Payment from an approved superannuation fund [section 10(13)]:*** Any payment from an approved superannuation fund made:

(a) on the death of the beneficiary; or

(b) to an employee in lieu of or in commutation of an annuity on his retirement at or after a specified age or on his becoming incapacitated prior to such retirement; or

(c) by way of refund of contributions on the death of the beneficiary; or

(d) by way of refund of contributions to an employee on his leaving the service in connection with which the fund is established otherwise than by retirement at or after a specified age or at his becoming incapacitated from service prior to such retirement to the extent to which such payment does not exceed the contributions made prior to the commencement of this Act, i.e., 1.4.1962, and also any interest thereon, would be wholly exempt from tax.

21. ***House Rent Allowance (HRA) [Section 10(13a)]:*** Any special allowance specifically granted to an employee by his employer to meet expenditure actually incurred on payment of rent in respect of residential accommodation occupied by the assessee, is exempt to the extent of least of the following:

(a) Actual amount of such allowance received in respect of the relevant period; or

(b) Rent paid over 10% of salary [Rent paid – 10% of salary]

(c) An amount equal to one-half of the amount of salary due to the assessee in respect of the relevant period where such accommodation is situated at Mumbai, Kolkata, Delhi or Chennai and where such accommodation is situated at any other place, two-fifth of the amount of salary due to the assessee in respect of the relevant period.

Caution Following points should be kept in mind while providing exemption for HRA:

1. Salary = Basic Pay + D.A. (If form part of retirement benefit) + Commission (If it is based on specific % of turnover). Thus 'Salary' includes Basic pay, dearness allowance, if the terms allow, includes commission, but excludes all other allowances and perquisites.

2. 'Relevant period' means the periods during which the said accommodation was occupied by the assessee during the previous year.

22. ***Special allowance [Section 10(14)]:*** Any special allowance in cash or the value of any benefit granted by the employer to an employee with the specific object of enabling the employee to meet expenses 'wholly', 'necessarily' and 'exclusively' incurred by him in the performance of the duties of his office or employment of profit, is exempt from tax to the extent to which such expenses are actually incurred for that purpose. This allowance may include travelling allowance to agents, conveyance allowance, transfer allowance, etc., but it does not include entertainment allowance, perquisites and the allowance to meet personal expenses (i.e. City Compensatory Allowance) at the place where the duties of office are performed by him or at the place where he ordinarily resides.

Did u know? City Compensatory Allowance or CCA is an allowance paid by the employer to compensate high cost of living incurred by an employee in big cities.

23. ***Scholarships [Section 10(16)]:*** Scholarships granted to meet the cost of education would be exempt in every case regardless of the residential status or citizenship of the scholar and the person from whom the scholarships are received.

24. ***Daily Allowances of MPs and MLAs [Section 10(17)]:*** The provisions in this regard are as follows:

    Any income by way of:

    (a) daily allowance received by any person by reason of his membership of Parliament or of any State legislature or of any Committee thereof;

    (b) any allowance received by any person by reason of his membership of Parliament under the Members of Parliament (Constituency Allowance) Rules, 1986;

    (c) any constituency allowance received by any person by reason of his membership of any State Legislature under any Act or rules made by that State Legislation.

25. ***Awards or rewards [Section 10(17A)]:*** Any payments made, whether in cash or in kind, in pursuance of any award instituted in the public interest by the Government or instituted by any other body and approved by the Central Government or as a reward by the Government for such purposes as may be approved by the Central Government in the public interest.

26. ***Pension [Section 10(18)]:*** A new clause 10(18) has been inserted by Finance Act, 1999 with effect from 1.4.2000 to provide that any income by way of pension received by an individual or family pension received by any member of the family of such individual shall be exempt if such individual has been in the service of Central or State Government and has been awarded Param Vir Chakra or Maha Vir Chakra or Vir Chakra or such other gallantry award as may be notified.

27. ***Family pension [Section 10(19)]:*** Family pension received by the widow or children or nominated heirs, as the case may be, of a member of the armed forces (including paramilitary forces) of the Union, where the death of such member has occurred in the course of operational duties, in such circumstances and subject to such conditions, as may be prescribed, shall be exempt from tax. However, family pension received by others is exempt upto least of '15,000 or 1/3rd of family pension and it is taxable under the head other sources.

28. ***Annual value of palace of a ruler [Section 10(19A)]:*** The annual value of any one palace in the occupation of a Ruler would be exempt if it was exempt from income tax before the commencement of the Constitution Twenty-Sixth (Amendment) Act, 1971 by virtue of the provisions of the Merged States (Taxation Concessions) Order, 1949 or any other taxation

concession order. Annual value of the entire building is exempt even though a portion only is occupied by the ruler

29. ***Income of local authorities [Section 10(20)]:*** The income of a local authority which is chargeable under the head 'Income from house property', 'Capital gains' or 'Income from other sources' or even from a trade or business carried on by it which accrues or arises from the supply of commodities or services (other than water or electricity) within its own jurisdictional area or from the supply of water or electricity within or outside its own jurisdictional area would be wholly exempt from income-tax.

30. ***Pension fund of LIC [Section 10(23AAB)]:*** The Income of the Life Insurance Corporation of India or any other insurer to the extent it is from a fund set up under a pension scheme to which contribution is made by any person for receiving pension from such fund is exempt from tax provided the pension scheme is approved by the Controller of Insurance or the Insurance Regulatory and Development Authority established under Sub-section (1) of Section 3 of the Insurance Regulatory and Development Authority Act, 1999, as the case may be.

31. ***Income of research associations [Section 10(21)]:*** Any income of a Research Association, approved for the purposes of Section 35(1)(ii)(iii) shall be exempt from tax if the Research Association applies its income or accumulates it for application, wholly and exclusively, to the objects for which it is established and the provisions of Section 11(2) and (3) shall be applicable to such accumulations with due adaptations for the purposes of scientific research or research in social science or statistical research and it does not invest or deposit its funds, other than:

    (a) any assets held by the research association where such assets form part of the corpus of the fund of the association as on the first day of June, 1973;

    (b) any assets (being debentures issued by or on behalf of, any company or corporation) acquired by the research association before the 1st day of March, 1983;

    (c) any accretion to the shares forming part of the corpus of the fund mentioned by way of bonus shares allotted to the research association;

    (d) voluntary contribution received and maintained in the form of jewellery, furniture or any other article as the Board may by notification in the official gazette, specify, for any period during the previous year otherwise than in the forms and modes as specified in Section 11(5).

    However, the exemption under this clause shall not be denied in relation to voluntary contribution, other than voluntary contribution in cash or voluntary contribution of the nature referred to (a), (b), (c) and (d) above, subject to condition that such voluntary contribution is held by the research association only in the forms or modes as specified in Section 11(5) after the expiry of one year from the end of the previous year in which such asset is acquired or the 31st day of March, 1992 whichever is later.

    Further, the exemption under this clause to any profits and gains of business carried on by the research association shall be available if the business is incidental to the attainment of its objectives and separate books of account are maintained in respect of such business.

Caution The exemption under this clause shall be withdrawn if the Central Government is satisfied that the conditions are not being fulfilled but an opportunity of being heard shall be provided.

32. ***Income of a regimental fund or non-public fund [Section 10(23AA)]:*** Income derived by any Regimental Fund or Non-Public Fund established by the armed forces of the Union for the welfare of their past and present members and their dependents will be exempt from tax.

33. ***Income of a mutual fund [Section 10(23D)]:*** Subject to the provisions of Chapter XIIE any income of a Mutual Fund set up by a public sector bank or a public financial institution or authorised by the Securities and Exchange Board of India or the Reserve Bank of India is exempt from tax. This exemption is subject to such conditions as the Central Government may, by notification in the Official Gazette, specify in this behalf. However, these conditions are not applicable in case of a Mutual Fund is registered under the SEBI.

34. ***Income of investor protection fund (Section 23EA):*** Any income by way of contributions received from recognized stock exchanges and members thereof, of such Investor Protection Fund set up by recognised stock exchanges in India, either jointly or separately, as the Central Government may, by notification in the Official Gazette, specify in this behalf.

Caution Provided that where any amount standing to the credit of the Fund and not charged to income-tax during any previous year is shared, either wholly or in part, with a recognised stock exchange, the whole of the amount so shared shall be deemed to be the income of the previous year in which such amount is so shared and shall accordingly be chargeable to income-tax.

35. ***Income of venture capital company [Section 10(23FB)]:*** Any income of a venture capital company or venture capital fund set up to raise funds for investment in a venture capital undertaking is exempt from the assessment year 2001–02.

Did u know? Venture Capital Company means such company:

(i) Which has been granted a certificate of registration under the Securities and Exchange Board of India Act, 1992 (15 of 1992), and regulations made thereunder;

(ii) Which fulfils the conditions as may be specified, with the approval of the Central Government, by the Securities and Exchange Board of India, by notification in the Official Gazette, in this behalf.

36. ***Income of a registered trade union [Section 10(24)]:*** Any income chargeable under the head 'income from house property' and income from other sources of a registered Trade Union within the meaning of the Indian Trade Unions Act, 1926, formed primarily for the purposes of regulating the relations between workmen and the employers or between the workmen and the workmen is exempt from income-tax and also of a federation of such unions.

37. ***Income of minor child [Section 10(32)]:*** Where the income of an individual includes any income of his minor child in terms of Section 64(1A), such individual shall be entitled to exemption of the amount includible under Section 64(1A) of each minor child or ₹ 1,500 for each minor child whichever is less.

Task Discuss in a group who is a minor as per Income Tax Act.

38. ***Income from transfer of units of UTI [Section 10(33)]:*** Any income arising from the transfer of a capital asset, being a unit of the Unit Scheme, 1964 referred to in Schedule I to the Unit Trust of India (Transfer of Undertaking and Repeal) Act, 2002 (58 of 2002) and where the transfer of such asset takes place on or after the 1st day of April, 2002 shall be exempt from income tax.

39. ***Any income by way of dividends referred to in Section 115-O [Section 10(34)]:*** Any income by way of dividends referred to in Section 115-O shall be exempt from income tax. As per section 115O the company paying or declaring any dividend have to pay tax @15% plus surcharge 5% plus education cess @3% on such dividend. Hence, such dividend shall be exempt in the hands of shareholders.

40. ***Income from Mutual Funds and certain units [Section 10(35)]:*** Any income by way of:

    (a) income received in respect of the units of a Mutual Fund specified under Clause (23D); or

    (b) income received in respect of units from the Administrator of the specified undertaking; or

    (c) income received in respect of units from the specified company shall be exempt from income tax.

    This clause shall not apply to any income arising from transfer of units of the Administrator of the specified undertaking or of the specified company or of a mutual fund, as the case may be.

41. ***Income from subsidiary company [Section 10(40)]:*** Any income of any subsidiary company by way of grant or otherwise received from an Indian company, being its holding company engaged in the business of generation or transmission or distribution of power if receipt of such income is for settlement of dues in connection with reconstruction or revival of an existing business of power generation shall be exempt from income tax.

42. ***Income from transfer of a capital asset [Section 10(41)]:*** Any income arising from transfer of a capital asset, being an asset of an undertaking engaged in the business of generation or transmission or distribution of power where such transfer is effected on or before the 31st day of March, 2006, to the Indian company notified under sub-clause (a) of clause (v) of Sub-section (4) of Section 80-IA shall be exempt from income tax.

Self Assessment

Fill in the blanks:

5. Any sum received by an individual in his capacity as a member of H.U.F. is ………………………. exempt from income-tax.

6. Share income of a person being …………………. of a firm which is separately assessed as such is exempt from tax.

7. Allowances or perquisites paid or allowed as such outside India by …………………….. to a citizen of India for his services rendered outside India, would be wholly exempt from income-tax.

8. As per ……………………. the amount of tax actually paid by an employer, at his option, on non-monetary perquisites on behalf of an employee, is not taxable in the hands of the employee.

9. The provident fund set-up by the Central Government and notified by it in the Official Gazette is known as ……………………..

4.3 Tax exemptions for Charitable Trusts and Institutions

Before the discussion of the provisions of the Income Tax Act in this connection, it is important to note the meanings of some terms like 'Trust', 'Institution', and 'Income' from property, charitable purpose and Religious purpose. These are discussed as under:

1. ***Trust:*** Section 3 of the Indian Trusts Act defines a trust to mean "an obligation annexed to the ownership of property and arising out of a confidence reposed in and accepted by the owner, or declared and accepted by him for the benefit of another and the owner".

2. ***Institution:*** An organisation with a constitution composed of a President, Vice-President, Secretary, Committee Members and ordinary members, is known as an Institution. The activities of the institution and its office-holders are regulated by rules and bye-laws of the institution. A university or a Chamber of Commerce is an Institution.

Did u know? Founded in 1925, Indian Chamber of Commerce (ICC) is the leading and only National Chamber of Commerce operating from Kolkata, and one of the most proactive and forward-looking Chambers in the country today. Its membership spans some of the most prominent and major industrial groups in India.

3. ***Income from property:*** This includes income from movable or immovable property, voluntary donations received and income from business undertaking(s) held by the trust.

4. ***Charitable purpose:*** The term 'charitable purpose' has been defined in this Act in a wider sense than what is commonly understood. According to Section 2(15) of the Act, it includes relief of the poor, education, medical relief, preservation of environment (including watersheds, forests and wildlife) and preservation of monuments or places or objects of artistic or historic interest and advancement of any other object of general public utility not involving the carrying on of any activity for profit.

In order to qualify for tax exemptions the charity must be of a public character, and the trust or institution should not be created or established for the benefit of any particular religious community or caste, if the trust or institution is established for the benefit of the member of a club or employees of a factory, it would not be a public charitable trust. Vide Circular No. 395 dated Sept. 24, 1984 promotion of sports and games is considered to be a charitable purpose within the meaning of Section 2(15). Accordingly an association or institution, engaged in the promotion of sports or games can claim exemption under Section 11, even if it is not approved under Section 10(23).

Caution If advancement of any other object of general public utility involves any activity in the nature of trade, commerce or business or any activity of rendering any service in relation to any trade, commerce for any fee shall not considered as charitable purpose however this restriction shall be applicable only if total receipts from these activities exceeds ₹ 25 lakh in a previous year.

Self Assessment

State whether the following statements are true or false:

10. Section 3 of the Indian Trusts Act defines a trust.

11. An organisation with a constitution composed of a President, Secretary, and Committee Members is known as an Institution.

12. A university or a Chamber of Commerce is an Institution.
13. Income from property includes income from only immovable property, voluntary donations received and income from business undertaking(s) held by the trust.
14. An association or institution, engaged in the promotion of sports or games cannot claim exemption under Section 11, even if it is not approved under Section 10(23).

4.4 Income Not to be Included in the Total Income

According to Section 11(1), the following items of income are not to be included in the total income of the previous year of the assessee who is in receipt of the same:

1. ***Income derived from property held under trust wholly for charitable or religious purposes:*** Income derived from property held under trust wholly for charitable or religious purposes shall be exempt to the extent to which such income is applied for such purposes in India and where any such income is accumulated or set apart for application to such purposes in India, to the extent to which the income so accumulated or set apart is not in excess of 15% of the income from such property.
2. ***Income derived from property held under trust in part only for charitable or religious purposes:*** Income derived from property held under trust in part only for charitable or religious purposes shall be exempt. This exemption would, however, be available only for trusts created before 1.4.1962.

> *Notes* Where any such income is finally set apart for application to such purposes in India, shall be exempt to the extent to which the income so set apart is not in excess of 15% of the income from such property.

3. ***Income from property held under trust created on or after 1.4.1952 for a charitable purpose*:** Income from property held under trust created on or after 1.4.1952 for a charitable purpose which tends to promote international welfare in which India is interested shall be exempt to the extent to which such income is applied for such charitable purposes outside India.
4. ***Income from property held under trust created before 1.4.1952 for charitable or religious purposes:*** Such income shall be exempt to the extent to which such income is applied for such purposes outside India. This exemption is, however, subject to the condition that the Central Board of Direct Taxes has, by a general or special order, issued a direction in either of the above two cases that the income in question would not be included in the total income of the person in receipt of such income.
5. ***Voluntary contribution:*** Income in the form of voluntary contributions made with a specific direction that they shall form part of the corpus of the trust or institution shall be fully exempt.

Self Assessment

Fill in the blanks:

15. Income derived from property held under trust in part only for charitable or religious purposes shall be ………………..from tax.
16. Income from property held under trust created on or after ……………… for a charitable purpose which tends to promote international welfare in which India is interested shall be exempt.

17. Income from property held under trust created before 1.4.1952 for charitable or religious purposes is subject to conditions by …………………………

18. Income in the form of …………………..made with a specific direction that they shall form part of the corpus of the trust or institution shall be fully exempt.

4.5 Income from Voluntary Contributions (Section 12)

The income of a trust by way of voluntary contributions would also be treated for all purposes as income deemed to have been derived by the trust from property held by it under trust except, however, in case where the voluntary contribution is received with a specific direction that it shall form part of the corpus of the trust. As a result, voluntary contribution received by a trust should also be applied for charitable purposes before the end of the accounting year or within 3 months following so that income-tax exemption could be availed of. However, voluntary contributions could be accumulated for future obligation for charitable purposes in the same manner as specified earlier.

The value of any services, being medical or educational services, made available by any charitable or religious trust running a hospital or medical institution or an educational institution, to any person referred to in Clause (a) or Clause (b) or Clause (c) or Clause (cc) or Clause (d) of Sub-section (3) of Section 13, shall be deemed to be income of such trust or institution derived from property held under trust wholly for charitable or religious purposes during the previous year in which such services are so provided and shall be chargeable to income-tax notwithstanding the provisions of Sub-section (1) of Section 11.

Caution For the purposes of this sub-section, the expression "value" shall be the value of any benefit or facility granted or provided free of cost or at concessional rate to any person referred to in Clause (a) or Clause (b) or Clause (c) or Clause (cc) or Clause (d) of Sub-section (3) of Section 13.

Notwithstanding anything contained in Section 11, any amount of donation received by the trust or institution in terms of Clause (d) of Sub-section (2) of Section 80G which has been utilised for purposes other than providing relief to the victims of earthquake in Gujarat or which remains unutilized in terms of Sub-section 5(C) of Section 80G in respect of which accounts of income and expenditure have not been rendered to the authority prescribed under clause (v) of sub-section (5C) of that section, in the manner specified in that clause, and not transferred to the Prime Minister's National Relief Fund on or before the 31st day of March, 2004 shall be deemed to be the income of the previous year and shall accordingly be charged to tax.

Task Discuss how Income in the form of voluntary contribution made with a specific direction which shall form part of the corpus of the trust or institution shall be fully exempt.

Self Assessment

State whether the following statements are true or false:

19. The income of a trust by way of voluntary contributions would also be treated for all purposes as income deemed to have been derived by the trust from property held by it under trust except.

20. Voluntary contributions cannot be accumulated for future obligation for charitable purposes in the same manner as specified earlier.

21. The value of any services, being medical or educational services, made available by any charitable or religious trust running a hospital or medical institution or an educational institution, to any person referred shall be deemed to be income of such trust or institution derived from property.

4.6 Income to be Included in Total Income

The exemption granted by Sections 11 or 12 of the Act would not, however, be available in the following cases and circumstances:

1. Where any part of the income from property held under trust for private religious purposes does not ensure for the benefit of the public;

2. In the case of a trust for charitable purposes or an institution created or established for charitable purposes on or after 1.4.1962, any income of the trust will not qualify for tax exemption if the trust or institution is created or established for benefit of any particular religious community or caste. By virtue of explanation 2 to Section 13, any trust created for the benefit of Scheduled Castes, backward classes, or Scheduled Tribes or women or children would not be deemed to be a trust or institution created or established for the benefit of any particular religious community or caste for purposes of this exemption. Consequently, income derived by trusts or institutions established purely for the benefit of scheduled castes or tribes or backward classes or women or children would qualify for tax exemption even though the income is applied in reality for the benefit of a particular community or caste.

3. In the case of a trust or institution established after 1.4.1962 or in the case of a trust, whenever created or established, if the income of the trust or institution is applied during the accounting year, directly or indirectly for benefit of any of the specified persons or if under the terms of the trust or the rules governing that institution, any part of the income of the trust ensures for the benefit of such specified persons, whether directly or indirectly, the trust would not be given tax exemption under Section 11, with the exception that (i) where such use or application is by way of compliance with a mandatory term of the trust or a mandatory rule governing the institution, and (ii) where such use or application relates to any period before the 1st day of June, 1970, the aforementioned provision shall not apply.

4. Where any business is owned by a religious or charitable trust or institution, the income of such business shall be determined by the Assessing Officer in the same way as the assessment of business income of any other assessee. Consequently, any additions to the business income shown in the accounts of the assessee made by the Assessing Officer is deemed to be income applied by the trust for purposes other than charitable or religious. Such additions, therefore, do not qualify for tax exemptions under Section 11(4).

However, in the case of a trust or institution established before 1.4.1962, the exemption would not be forfeited merely on the ground that a part of the income or property of the trust or institution is applied directly or indirectly for the benefit of the specified persons if such use or application is for compliance with a mandatory term of the trust or a mandatory rule governing the institution.

For purposes of the disallowance of exemption, the ‘specified persons’ are the following namely:

- the author of the trust or the founder of the institution,

- any person who has made a substantial contribution to the trust or institution, that is to say, any person whose total contribution up to the end of the relevant previous year exceeds ₹ 25,000,
- where the author, founder or other substantial contributor is a Hindu Undivided Family, any member of the family,
- any trustee of the trust or manager, by whatever name called, of the institution,
- any relative of such author, founder, person, member, trustee or manager, referred to above, and
- any concern in which any of the above mentioned persons has a substantial interest.

Notes The expression 'relative' used for this purpose has been defined in the Explanation (1) to Section 13 to mean:

(a) the spouse of the individual,

(b) brother or sister of the individual,

(c) the brother or sister of the spouse of the individual,

(d) any lineal ascendant or descendant of the individual,

(e) any lineal ascendant or descendant of the spouse of the individual, and

(f) the spouse of any of the persons referred to in (b) to (e) above and any lineal ascendant or descendant of a brother or sister of either the individual or the spouse of the individual.

The income or the property of the trust or institution or any part thereof shall be deemed to have been used or applied for the benefit of the specified persons and consequently the trust will forfeit its exemption from income tax in the following cases specified in Section 13(2):

1. Where any part of the income or property of the trust or institution is, or continues to be lent to any of the specified persons for any period during the previous year without either adequate security or adequate interest or both;
2. If any land, building or other property of the trust or institution is or continues to be made available for the use of any of the specified persons for any period during the previous year without charging adequate rent or other compensation;
3. If any amount is paid by way of salary, allowance or otherwise during the previous year to any of the specified persons out of the resources of the trust or institution for service rendered by that person to such trust or institution and the amount so paid is in excess of what may reasonably be paid for such service;
4. If the services of the trust or institution are made available to any of the specified persons during the previous year without adequate remuneration or other compensation;
5. If any security, share or other property is purchased by or on behalf of the trust or institution from any of the specified persons during the previous year for a consideration which is more than adequate;
6. If any share, security or other property is sold by or on behalf of the trust or institution to any of the specified persons during the accounting year for a consideration which is less than adequate;

7. If any income or property of the trust or institution is diverted during the previous year in favour of any of the specified persons. However, if the total value of the income and/or property so diverted does not exceed ₹ 1,000 in value, the trust will not forfeit the exemption merely because any portion of the income or property of the trust is diverted for the benefit of any of the specified persons; and

8. If any funds of the trust or the institution are, or continue to remain, invested for any period during the accounting year in any concern in which any of the specified persons has a substantial interest.

For purposes of disallowance of the exemption to a charitable trust or institution the specified persons shall be deemed to have a substantial interest in a concern under the following circumstances:

- ***In case where the concern is a company:*** If its equity shares carrying not less than 20% of the total voting power are, at any time during the previous year, owned beneficially by such person or partly by such person and partly by one or more of the other specified persons, or

- ***In the case of any other concern:*** If such specified persons are entitled individually or jointly to not less than 20% of the profits of such concern at any time during the relevant accounting year.

Where the trust funds are invested in a concern in which any of the specified persons has a substantial interest and the quantum of the investment does not exceed 5% of the capital of the concern, the exemption shall not be allowed in respect of the income arising from such investment and the remaining income will continue to enjoy exemption from tax.

Further for debentures of an Indian company or Corporation acquired by the trust or institution after 28 February, 1983 but before 25th July, 1991, the exemption from tax under Section 11 or Section 12 shall be allowed to the trust or institution in respect of interest on such debentures if the trust or institution disinvests such debentures latest by 31st March, 1992.

Any charitable or religious trust or institution will forfeit exemption from tax if any funds of the trust or institution are invested or deposited, after February 28, 1983, otherwise than in any one or more of the modes specified in Section 11(5). Such trusts and institutions will also forfeit exemption from tax if any part of their funds invested before March 1, 1983 otherwise than in any one or more of the forms or modes specified in Section 11(5) continue to remain so invested or deposited after November 30, 1983. Trusts or institutions which continue to hold any shares in a company (other than a Government company or a statutory corporation) after the said date will also forfeit exemption from income-tax.

The aforesaid provisions will, however, not apply in relation to assets which constituted the original corpus of the trust or institution as on June 1, 1973 and any accretion to the assets being shares of a company forming part of the corpus of the trust or institution as on June 1, 1973, where such accretion arises by way of bonus shares.

The aforesaid provisions will also not apply in relation to assets (being debentures issued by a company) acquired by the trust/institution before March 1, 1983. Further, it will not apply in relation to any asset [other than an investment or deposit in the mode or form as specified in Section 11(5)] which is held after the expiry of one year from the end of the previous year in which such asset is acquired or the 31st Day of March, 1993 whichever is later in the mode and form as specified in Section 11(5). Also, it will not apply in relation to any funds representing the profits and gains of business relevant to the assessment year 1984-85 or any subsequent year.

Notwithstanding anything contained in Sub-section (1) or Sub-section (2), but without prejudice to the provisions contained in Sub-section (2) of Section 12, in the case of a charitable or religious trust running an educational institution or a medical institution or a hospital, the exemption under Section 11 or Section 12 shall not be denied in relation to any income, other than the income referred to in Sub-section (2) of Section 12, by reason only that such trust has provided educational or medical facilities to persons referred to in Clause (a) or Clause (b) or Clause (c) or Clause (cc) or Clause (d) of Sub-section (3).

If the trust or institution has any other income in addition to profits and gains of business, for getting exemption under this clause separate books of account in respect of such business are to be maintained.

Did u know? *Business income of charitable trusts:* The exemption from income- tax will not be denied to any religious or charitable trust in respect of profits or gains of business provided that:

(a) the business is carried on by a trust wholly for public religious purposes and the business consists of printing and publication of books or is of a kind notified by the Government, or

(b) the business is carried on by an institution wholly for charitable purposes and the work in connection with the business is mainly carried on by the beneficiaries of the institution and, separate books of account are maintained by the trust/institution of such business.

As per Section 13(7), nothing contained in Section 11 or 12 shall operate so as to exclude from the total income of the previous year of the person in receipt thereof, any anonymous donation referred to in Section 115BBC on which tax is payable in accordance with the provisions of that section.

A new sub-section (8) to section 13 has been inserted by the Finance Act, 2012 which provides that nothing contained in section 11 or section 12 shall operate so as to exclude any income from the total income of the previous year of the person in receipt thereof if the provisions of the first proviso to clause (15) of section 2 become applicable in the case of such person in the said previous year.

Self Assessment

Fill in the blanks:

22. In the case of a trust for charitable purposes or an institution created or established for charitable purposes on or after 1.4.1962, any income of the trust will not qualify for tax exemption if it is established for the benefit of any …………………….

23. Where any business is owned by a religious or charitable trust or institution, the income of such business shall be determined by the ……………………. in the same way as the assessment of business income of any other assessee.

24. The expression 'relative' used for this purpose has been defined in the Explanation (1) to ………………………

25. If the trust or institution has any other income in addition to profits and gains of business, for getting exemption under this clause separate ……………………. in respect of such business are to be maintained.

4.7 Tax Exemptions to Political Parties

'Political party' means an association or body of individual citizens of India registered with the Election Commission of India as a political party and includes a political party deemed to be registered with that Election Commission of India.

Political parties are liable to pay tax on their income and they are assessed as 'An association of persons'. However, the income derived by these parties as income by way of voluntary contributions, Income from House Property; and Income from Other Sources or Capital Gains are exempt from subject to the following conditions:

(a) the party keeps and maintains such books of account and other documents as would enable the Assessing Officer to properly deduce the income;

(b) in respect of each such voluntary contribution in excess of ₹ 20,000, the party keeps and maintains a record of the contributions and names and addresses of the persons who have made such contribution; and

(c) the accounts of the party are audited by a Chartered Accountant or other qualified accountant.

The Chief Executive Officer of the political party is required to file a return of income if the total income (computed under this Act without giving effect to the provisions of Section 13A) exceeds the maximum amount which is not chargeable to income-tax. In this connection, the provisions of Section 139(1) shall apply.

Did u know? **Voluntary contributions received by an electoral trust**

Any voluntary contributions received by an electoral trust shall not be included in the total income of the previous year of such electoral trust, if:

(a) such electoral trust distributes to any political party, registered under section 29A of the Representation of the People Act, 1951, during the said previous year, ninety-five per cent of the aggregate donations received by it during the said previous year along with the surplus, if any brought forward from any earlier previous year; and

(b) such electoral trust functions in accordance with the rules made by the Central Government.

Notes 'Electoral Trust' means a trust so approved by the Board in accordance with the scheme made in this regard by the Central Government.

Self Assessment

Fill in the blanks:

26. ………………………….means an association or body of individual citizens of India registered with the Election Commission of India as a political party and includes a political party deemed to be registered with that Election Commission of India.

27. Political parties are liable to pay tax on their income and they are assessed as ………………………..

28. The ……………………..of the political party is required to file a return of income if the total income exceeds the maximum amount which is not chargeable to income-tax.

29. …………………………..means a trust so approved by the Board in accordance with the scheme made in this regard by the Central Government.

4.8 Allowable Deductions from Gross Total Income

There are different tax saving options i.e. Allowable Deductions or Exemption under Income Tax, are given under chapter VIA of the Income Tax Act, 1961. Summary of different tax saving section under which person can claim deduction or exemption from total Income are given below:

1. ***Section 80C:*** This section has been introduced by the Finance Act 2005. Broadly speaking, this section provides deduction from total income in respect of various investments or expenditures or payments in respect of which tax rebate u/s 88 was earlier available. The total deduction under this section (along with section 80CCC and 80CCD) is limited to ₹ 1 lakh only. These include:

   (a) Life Insurance Premium for individual, policy must be in self or spouse's or any child's name. For HUF, it may be on life of any member of HUF.

   (b) Sum paid under contract for deferred annuity for individual, on life of self, spouse or any child.

   (c) Sum deducted from salary payable to Govt. Servant for securing deferred annuity for self-spouse or child Payment limited to 20% of salary.

   (d) Contribution made under Employee's Provident Fund Scheme.

   (e) Contribution to PPF for individual can be in the name of self/spouse, any child and for HUF, it can be in the name of any member of the family.

   (f) Contribution by employee to a Recognised Provident Fund.

   (g) Sum deposited in 10 year/15 year account of Post Office Saving Bank

   (h) Subscription to any notified securities/notified deposits scheme. e.g. NS

   (i) Subscription to any notified savings certificate, Unit Linked Savings certificates. E.g. NSC VIII issue.

   (j) Contribution to Unit Linked Insurance Plan of LIC Mutual Fund e.g. Dhanrakhsa 1989

   (k) Contribution to notified deposit scheme/Pension fund set up by the National Housing Scheme.

   (l) Certain payment made by way of instalment or part payment of loan taken for purchase or construction of residential house property.

Caution Condition has been laid that in case the property is transferred before the expiry of 5 years from the end of the financial year in which possession of such property is obtained by him, the aggregate amount of deduction of income so allowed for various years shall be liable to tax in that year.

Notes

(m) Contribution to notified annuity Plan of LIC (e.g. Jeevan Dhara) or Units of UTI/ notified Mutual Fund. If in respect of such contribution, deduction u/s 80CCC has been availed of rebate u/s 88 would not be allowable.

(n) Subscription to units of a Mutual Fund notified u/s 10(23D).

(o) Subscription to deposit scheme of a public sector, company engaged in providing housing finance.

(p) Subscription to equity shares or debentures forming part of any approved eligible issue of capital made by a public company or public financial institutions.

(q) Tuition fees paid at the time of admission or otherwise to any school, college, university or other educational institution situated within India for the purpose of full time education of any two children. Available in respect of any two children

2. ***Section 80CCC - Deduction in respect of Premium Paid for Annuity Plan of LIC or Other Insurer:*** Payment of premium for annuity plan of LIC or any other insurer Deduction is available upto a maximum of ₹ 100,000/-. (This limit has been increased from ₹ 10,000/- to ₹ 1,00,000/- w.e.f. 01.04.2007). The premium must be deposited to keep in force a contract for an annuity plan of the LIC or any other insurer for receiving pension from the fund.

> *Notes* The limit for maximum deduction available under Sections 80C, 80CCC and 80CCD(1) (combined together) is ₹ 1,00,000 (₹ one lac only). An additional deduction upto a maximum of ₹ 20,000 will be available from Assessment Year 2011–12 (FY 2010–11) for investment in Infrastructure Bonds.

3. ***Section 80CCD (1) - Deduction in respect of Contribution to Pension Account (by Assessee}:*** Deduction available for the amount paid or deposited in a pension scheme notified or as may be notified by the Central Government subject to a maximum of:

(a) 10% of salary in the previous year in the case of an employee

(b) 10% of gross total income in any other case.

4. ***Section 80CCD (2) - Deduction in respect of Contribution to Pension Account (by Employer}:*** Deduction available for the amount paid or deposited by the employer of the assessee in a pension scheme notified or as may be notified by the Central Government subject to a maximum of 10% of salary in the previous year.

5. ***Section 80CCG – Rajiv Gandhi Equity Saving Scheme (RGESS):*** As per the Budget 2012 announcements, a new scheme Rajiv Gandhi Equity Saving Scheme (RGESS) will be launched. Those investors whose annual income is less than ₹ 10 lakh (proposed ₹ 12 lakh from A.Y. 2014–15) can invest in this scheme up to ₹ 50,000 and get a deduction of 50% of the investment. So if you invest ₹ 50,000 (maximum amount eligible for income tax rebate is ₹ 50,000), you can claim a tax deduction of ₹ 25,000 (50% of ₹ 50,000). View key features of Rajiv Gandhi Equity Saving Scheme (RGESS).

6. ***Section 80D- Deduction in respect of Medical Insurance:*** Deduction is available upto ₹ 20,000 for senior citizens and upto ₹ 15,000 in other cases for insurance of self, spouse and dependent children. Additionally, a deduction for insurance of parents (father or mother or both) is available to the extent of ₹ 20,000 if parents are senior Citizen and ₹ 15,000 in other cases. Therefore, the maximum deduction available under this section is to the extent of ₹ 40,000. From AY 2013–14, within the existing limit a deduction of upto ₹ 5,000 for preventive health check-up is available.

7. ***Section 80DD - Deduction in respect of Rehabilitation of Handicapped Dependent Relative:*** Deduction of ₹ 50,000 w.e.f. 01.04.2004 in respect of Expenditure incurred on medical treatment, (including nursing), training and rehabilitation of handicapped dependent relative. Payment or deposit to specified scheme for maintenance of dependent handicapped relative.

   Further, if the defendant is a person with severe disability a deduction of ₹ 1,00,000 shall be available under this section. The handicapped dependent should be a dependent relative suffering from a permanent disability (including blindness) or mentally retarded, as certified by a specified physician or psychiatrist. Note: A person with 'severe disability' means a person with 80% or more of one or more disabilities as outlined in section 56(4) of the 'Persons with disabilities (Equal opportunities, protection of rights and full participation)' Act.

8. ***Section 80DDB - Deduction in respect of Medical Expenditure on Self or Dependent Relative:*** A deduction to the extent of ₹ 40,000 or the amount actually paid, whichever is less is available for expenditure actually incurred by resident assessee on himself or dependent relative for medical treatment of specified disease or ailment. The diseases have been specified in Rule 11DD. A certificate in form 10 I is to be furnished by the assessee from any Registered Doctor.

9. ***Section 80E - Deduction in respect of Interest on Loan for Higher Studies:*** Deduction in respect of interest on loan taken for pursuing higher education. The deduction is also available for the purpose of higher education of a relative w.e.f. A.Y. 2008–09.

10. ***Section 80G - Deduction in respect of Various Donations:*** The various donations specified in Sec. 80G are eligible for deduction upto either 100% or 50% with or without restriction as provided in Sec. 80G

11. ***Section 80GG:*** Deduction in respect of House Rent Paid Deduction available is the least of

    a) Rent paid less 10% of total income

    b) ₹ 2000 per month i.e. Maximum Deduction available is 24,000

    c) 25% of total income,

    Provided:

    - Assessee or his spouse or minor child should not own residential accommodation at the place of employment.
    - He should not be in receipt of house rent allowance.
    - He should not have self-occupied residential premises in any other place.

12. ***Section 80GGA:*** Deduction in respect of certain donations for scientific research or rural development

13. ***Section 80GGC:*** Deduction in respect of contributions given by any person to political parties

14. ***Section 80QQB:*** Royalty Income on patents. Maximum deduction ₹ 3,00,000

15. ***Section 80RRB:*** Royalty Income to author of certain books other than text books. Maximum deduction ₹ 3,00,000

16. ***Section 80 TTA - Deduction from gross total income in respect of any Income by way of Interest on Savings account:*** Deduction from gross total income of an individual or HUF, upto a maximum of ₹ 10,000/-, in respect of interest on deposits in savings account

(not time deposits) with a bank, co-operative society or post office, is allowable w.e.f. 01.04.2012 (Assessment Year 2013–14).

17. ***Section 80U - Deduction in respect of Person suffering from Physical Disability:*** Deduction of ₹ 50,000 to an individual who suffers from a physical disability (including blindness) or mental retardation. Further, if the individual is a person with severe disability, deduction of ₹ 1,00,000 shall be available u/s 80U. Certificate should be obtained from a Govt. Doctor. The relevant rule is Rule 11D.

18. ***Deductions Allowable under Section 24 of Income Tax Act:*** Where a housing property has been acquired or constructed or repaired or renewed with borrowed capital, the amount of interest payable yearly on such capital is allowed as deduction under Section 24 of Income Tax Act, subject to the limits stated below. Penal interest on housing loan is not eligible for deduction. If a fresh loan has been raised to repay the original loan and the new loan has been used only for the purpose of repaying the original loan then, the interest accrued on such fresh loan is allowed for deduction.

If the property is acquired or constructed with the capital borrowed on or after 01-04-1999 and such acquisition or construction is completed within 3 years of the end of the financial year in which capital was borrowed then the actual interest payable is allowed as deduction subject to a maximum ₹ 1,50,000. In other case interest up to maximum ₹.30, 000 is deductible. The ceiling of ₹.1,50,000 or ₹ 30,000 is only in case the property is self occupied. There is no limit on deduction of interest if the property is let out.

Self Assessment

Fill in the blanks:

30. There are different tax saving options i.e. Allowable Deductions or Exemption under Income Tax, are given under ……………………..of the Income Tax Act, 1961.

31. ………………………..section has been introduced by the Finance Act 2005.

32. Payment of premium for annuity plan of LIC or any other insurer Deduction is available upto a maximum of ₹ …………………………

33. The various donations specified in Sec. 80G are eligible for deduction upto either …………………….with or without restriction as provided in Sec. 80G.

Case Study

Should Agricultural Income be Taxed in India?

For the last so many decades the agricultural income derived in India by tax payers of India is completely exempt from income-tax. A question now crops up in our minds are whether such agricultural income should be taxed right now. Those who are deriving the agricultural income will surely not like this income to be a part of the taxable income. But the fact remains that in a country like India where huge expenditure is still required for the development of the infrastructure and also because of the fact that the GDP ratio is not in tune with the desired benchmark and keeping all these factors in view, we can say that it is time now to tax the agricultural income of the agriculturists in India.

Substantial revenue will be collected by the Tax Department in case agricultural income is subjected to income-tax. However, the problem in India is that because of the politics of

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vote bank no government can dare to touch this subject matter namely of taxing the agricultural income of the agriculturists in India.

The fact remains that fiscal concessions are granted by the statute to certain categories of tax payers to achieve a particular goal. For example couple of years ago the exporters of India were granted complete tax holiday in respect of their foreign exchange earnings. Now the Government feels that this category of tax payers are right now out from the clutches of the problems and that is reason that export income is now subjected to income-tax. Whenever the point comes of taxing the agricultural income the eyes of the statute makers is focused on one single objective namely the impact on the next elections.

A real bold and dynamic approach is now needed in India whereby all the political parties and all the Chief Ministers of India organize a conclave to debate and discuss the issues concerning taxation of agricultural income in India.

Persons who are engaged in cultivation and produce agricultural income always enjoy the sympathy of the statute makers of the country. The rising trend in suicides being committed by agriculturists also goes to support the sympathy in favour of the agriculturists of the country. With the rise in the suicide rate by the agriculturists more and more sympathy goes in favour of agriculturists and at that point of time to think about taxing agricultural income might bring home a fear of more and more suicides being further committed by the agriculturists. With regard to suicides by agriculturists the Government should analyse the reason behind the committing of the suicide and should bring home positive ideas to control such suicides by the farmers of the country. But on the other hand taxing agricultural income should not be ignored keeping in view the rising money requirement of the country to meet fiscal deficit and to develop the infrastructure of the country.

In case income tax is levied on agricultural income without considering the real impact on the agriculturists, all those persons who are attached with the political parties would immediately jump upon to say that as a result of taxing the agricultural income, the poor farmer will virtually die because of the increased burden of income-tax on him in case agricultural income-tax is levied in the country.

If we analyse the land holding by individual persons in India, we would find that in majority of the cases the land holding is in the name of different family members of the farmer. As a result of land holding being available in different individual names in the family, the advantage is that each family member of the farmer will get income-tax exemption up to ₹ 2,00,000 per annum even if the agricultural income is subjected to income-tax. The practical impact of this can be seen from an example of a family of five persons of a farmer and in case agricultural income is subjected to tax but still all the five family members will have a combined income of ₹ 10 lakhs in a family which would be exempt from income-tax. This is the special advantage available to a farmer and this advantage is generally not available to all those tax payers in India who are not farmers. For example in another family of five persons where the head of the family is doing a job or running a shop, he finds that income-tax exemption is available of ₹ 2,00,000 only to him because other family members who are not working or who are not running their separate shops hence have no income. Hence, from practical angle also it can be argued with confidence that if agricultural income is subject to income-tax, even then the poor farmer will have no problem with regard to income-tax payment just because of the fact that the basic income-tax exemption of ₹ 2,00,000 per annum would equally be applicable to a farmer. Hence, the law makers in the country as well as the most respected parliamentarians of the country should now think of taxing agricultural income so that tax burden is at par for salaried employees, for businessman as well as for the persons carrying on agricultural activities.

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Similarly, the agriculturist, if income-tax is levied on him will also be able to save taxes over and above the basic income-tax exemption limit if he were to make investment by way of contribution to the Public Provident Fund or to a Life Insurance Policy within the framework of section 80C of the Income-tax Act, 1961. I personally feel that if income-tax is levied on agricultural income, the farmers of the country will be able to develop the habit of saving for their bright future in the years to come especially because of the income-tax provision granting tax deduction on certain investments etc., etc.

It is certain that in case agricultural income-tax is levied in India, the farmers of the country in next one decade will have more money power available at their disposal just because of the savings made by them through various investment channels so as to achieve a tax deduction in terms of section 80C of the Income-tax Act, 1961. Likewise, a farmer if he is taxed on the agricultural income apart from making a tax saving under section 80C will also be able to save income-tax like any other individual if he were to invest in a residential housing. Thus, the problem of the Government to provide housing for those who are in the villages can be a thing of the past once the agricultural income is subjected to tax and our agriculturists enjoy the same tax benefit which are available to other tax payers of the country whereby the end result after a decade would be more prosperity to the farmers, more housing being available to the farmers because of their own investment in housing sector and so on.

Driving in Mercedes cars are a common feature in Punjab particularly where large number of agriculturists buy luxury cars, luxury homes and luxury holidays. Tax Paying public of India is frustrated when they find that a tax payer doing hard work in his business after making payment of income-tax is not able to buy a Mercedes car but an agriculturist who is required to work much less in comparison with a person in a city goes scot-free for making investments in the manner he likes just because there is no income-tax on the agricultural income earned by him. Hence, if the Government takes a decision to levy tax on agricultural income, then surely the rich and famous agriculturists of India would be required to make payment of income-tax which will increase government revenue on the one hand and which will increase GDP ratio in the country and would finally help in the holistic development of the country.

Sometimes a question may also arise as to how an illiterate poor farmer will be able to comply with the formalities required for income-tax payment and maintenance of the accounts etc. to derive the taxable agricultural income. Well, the answer to this can be found out by reference to the provisions contained in the Income-tax Act especially in section 44AD whereby up to a turnover of ₹ 1 crore a person engaged in business can walk away without maintaining the accounts and is subjected to income-tax on a presumptive basis. Same set of provision can be applied even for taxing agricultural income whereby the poor and illiterate agriculturists also will not have any problem to comply with the provisions of income-tax law.

Again and again it may be noted that the so called poor small farmer in any case would be outside the clutches of payment of agricultural income-tax because the income in any case up to ₹ 2,00,000 per annum for every adult member of the farmer's family will be exempt from income-tax. I also strongly feel that if agricultural income-tax is levied in India, then it is possible that the farmers would be tempted to go in for research based new innovations in agriculture and would be seen using new technology, new machinery and new vistas to achieve higher agricultural output which will be helpful to the country. Hence, if agricultural income-tax is levied in India then fruit juice, ayurvedic herbs production and such other connected activities in agriculture will flourish and there would be desire amongst the agriculturists also to achieve more output from the land which they own.

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It is expected that dynamism amongst the agriculturists will be on fast track in case agricultural income-tax is levied in India.

Nation first and not just vote politics should be on the back of the mind of every political party if they really want to tax the agricultural income in India. It is often seen that while the tax payers of India feel cheated because they are being subjected to income-tax and persons deriving agricultural income specially the rich farmers are not being subjected to income-tax at all. A large number of politicians as well as a large number of business communities also owns substantial part of agricultural land in India and are deriving substantial tax free agricultural income. Hence, if agricultural income is subjected to income-tax in India, it is felt that there would be no agony or problem especially to these rich farmers because they would be placed at par with other tax payers of India earning big income and engaged in non-agricultural income producing activities.

If the Government finds that it is not ready right now to tax the entire agricultural income, in that situation they may initially exempt agricultural income by farmers having land holding up to five acres and likewise to start with, the Government may also exempt taxing agricultural income in case it is derived by cultivating rice, wheat and vegetables. The theme is that at least let there be a start for taxing the agricultural income of particularly the rich farmers and thereafter let the Government study its impact, the tax collection, the problems and then come to an amendment of taxing agricultural income. It is a fact that taxing agricultural income is a State subject but just like having a debate on GST with the States the Government should now have a debate with the States for taxing agricultural income. It is strongly felt that if agricultural income is taxed and in case the policy of taxing agricultural income is designed in a very scientific manner, then it will have no adverse impact on the common farmer but the Government would find easily substantial amount coming in its kitty from the agricultural income derived by rich farmers and rich corporates.

Way back in the year 1975 a Committee on Agriculture Taxation was headed by Dr. K.N. Raj. The recommendation of this Committee was to tax agricultural income of rich. However, the same was not made law. Similarly, eighty years ago Dr. B.D. Ambedkar who was a man with towering personality and a great visionary and his view was that he favoured taxing agricultural income with his sound reasoning. He was of the view that tax should be levied on tax paying capacity or income of the tax payer and that rich must be taxed more and poor less. It was Dr. Ambedkar who criticised land revenue by the British Government as it was against the interest of the poor but according to him tax on agricultural income should be levied. Later on the Taxation Enquiry Commission which was set up in the year 1953-54 also recommended the revision of tax laws taking into consideration the changes in the prices of agricultural produce.

Later on long term fiscal policy was introduced by the Government in the year 1985 and they also recognized the concept of taxing agricultural income. In short the fact is that almost all the commissions and agencies appointed or created by the Government in last sixty years have unanimously been of the view that agricultural income should be subjected to tax but the million dollars question is that who will bell the cat. The fact remains that the law makers could not dare to taxing agricultural income mainly because of the vote bank problem. It is at this point of time that when we are thinking of devising new vistas and new means to gather finances for the development of the country the theme of taxing agricultural income specially the rich agriculturists should be taken into consideration and that it is high time now that the agriculturists be brought in the tax net. The Government should make a study to bring agricultural income and non-agricultural income at par and for this purpose the Government should also analyse that the overall hard work done by

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the agriculturists be compared with hard work and long hours of work being put by a person in trade or industry or in service and then surely the Government would come to the conclusion that it is now high time to tax the agricultural income so that the rich and famous people do not walk away without contributing any money to the exchequer.

Finally, it is time now to think of taxing agricultural income and simultaneously the Government should also think of measures to enhance the income earning capacity of the agriculturists. In the first 2/3 years the entire income-tax recovered from taxing agricultural income should be spent by the Government in the development of agricultural activities and for the welfare of the agriculturists so that ultimately the agriculturist also reaps better fruits for his labour and the Government earns more revenue because of higher production of agriculture as a result of implementation of new technologies and new equipment being made available in the agriculture sector. A question we would now like to pose to each and every citizen of India is why not now the Government should be thinking on taxing agricultural income by rising above the politics and in the interest of nation building and equity to all categories of tax payers of India.

Questions

1. Study and analyse the case.
2. Write down the case facts.
3. What do you infer from it?

Source: http://www.moneycontrol.com/smementor/news/government-policy/should-agricultural-income-be-taxed-in-india-828150.html

4.9 Summary

- Tax exemption refers to a personal allowance or specific monetary exemption which may be claimed by an individual to reduce taxable income under some systems. Tax exempt status may provide a potential taxpayer complete relief from tax, tax at a reduced rate, or tax on only a portion of the items subject to tax.
- A tax deduction is a reduction of a taxpayer's total income that decreases the amount of money used in calculating the tax due.
- Section 10 provides that in computing the total income of a previous year of any person, any income falls in its ambit shall not be included in the total income, provided the assessee proves that a particular item of income is exempt and falls within a particular clause.
- Agricultural income as defined in Section 2(1A) is exempt from income-tax in the case of all assesses. This exemption has been granted on account of the constitutional provisions relating to the powers of the Central and the State Governments for levying tax on agricultural income.
- Any sum received by an individual in his capacity as a member of H.U.F. is wholly exempt from income-tax where such sum has been paid out of the income of the family, or out of the income of an impartible estate belonging to the family, because that has been taxed in hand of H.U.F.
- Share income of a person being a partner of a firm (including Limited Liability Partnerships) which is separately assessed as such is exempt from tax.
- Allowances or perquisites paid or allowed as such outside India by the Central Government to a citizen of India for his services rendered outside India, would be wholly exempt from income-tax.

- As per section 10(CC), the amount of tax actually paid by an employer, at his option, on non-monetary perquisites on behalf of an employee, is not taxable in the hands of the employee. Such tax paid by the employer shall not be treated as an allowable expenditure in the hands of the employer under section 40.
- The term 'charitable purpose' has been defined in this Act in a wider sense than what is commonly understood. According to Section 2(15) of the Act, it includes relief of the poor, education, medical relief, preservation of environment (including watersheds, forests and wildlife) and preservation of monuments or places or objects of artistic or historic interest and advancement of any other object of general public utility not involving the carrying on of any activity for profit.
- The income of a trust by way of voluntary contributions would also be treated for all purposes as income deemed to have been derived by the trust from property held by it under trust except, however, in case where the voluntary contribution is received with a specific direction that it shall form part of the corpus of the trust. As a result, voluntary contribution received by a trust should also be applied for charitable purposes before the end of the accounting year or within 3 months following so that income-tax exemption could be availed of. However, voluntary contributions could be accumulated for future obligation for charitable purposes in the same manner as specified earlier.
- 'Political party' means an association or body of individual citizens of India registered with the Election Commission of India as a political party and includes a political party deemed to be registered with that Election Commission of India. Political parties are liable to pay tax on their income and they are assessed as 'An association of persons'.

4.10 Keywords

AOP: It is an entity or a unit of assessment which is includes two or more persons who join for a common purpose with a view to earn an income.

Basic operation: These agricultural operations include tilling of the land, sowing of seeds, planting or an operation of a similar kind such as digging pits in the soil to plant a sapling etc.

Deduction: It is a reduction of a taxpayer's total income that decreases the amount of money used in calculating the tax due.

Electoral Trust: It is a trust so approved by the Board in accordance with the scheme made in this regard by the Central Government.

Exemption: It refers to a personal allowance or specific monetary exemption which may be claimed by an individual to reduce taxable income under some systems.

Hindu Undivided Family (HUF): It is a legal term related to the Hindu Marriage Act.

Keyman insurance policy: It means a life insurance policy taken by a person on the life of another person who is or was the employee of the first-mentioned person or is or was connected in any manner whatsoever with the business of the first-mentioned person.

Leave travel concession: It is defined as the cost of travel granted to employees to travel anywhere in India, while on leave from work.

Political party: It is an association or body of individual citizens of India registered with the Election Commission of India as a political party and includes a political party deemed to be registered with that Election Commission of India.

Receipt: The receipt of income refers to the first occasion when the recipient gets the money under his control.

Royalty: It is consideration also including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head 'Capital gains'.

Subsequent operations: These agricultural operations include weeding, digging the soil around the growth, nursing, pruning, cutting, etc.

4.11 Review Questions

1. Define and differentiate tax exemption from tax deductions.
2. Define agricultural income. Discuss its essential characteristics.
3. List down the income which is not treated as agricultural incomes.
4. Write a note on Partly Agricultural Income.
5. Explain the exemptions available on the Income of Research Associations.
6. Discuss in brief the tax exemptions for charitable trusts and institutions.
7. According to Section 11(1), provide a list of Income which are not to be included in the Total Income of an assessee.
8. Explain the treatment of tax exemption for Income from Voluntary Contributions.
9. The exemptions granted by Sections 11 or 12 of the Act are not be available under which all cases and circumstances.
10. Briefly explain the Tax exemptions to political parties.
11. What are the conditions to be satisfied to enable the Electoral Trust to claim full exemption?

Answers: Self Assessment

1. Exempt
2. Land
3. Rent
4. Basic operations
5. Wholly
6. Partner
7. Central government
8. Section 10(CC)
9. Public Provided Fund (PPF)
10. True
11. False
12. True
13. False
14. False
15. Exempt
16. 1st April 1952
17. CBDT
18. Voluntary contribution
19. True
20. False
21. True
22. Religious community or caste
23. Assessing officer
24. Section 13
25. Books of accounts
26. Political parties
27. AOP
28. Chief Executive Officer
29. Electoral trust
30. Chapter VIA

31. Section 80C

32. 1,00,000

33. 100% or 50%

4.12 Further Readings

Books

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Ahuja, G. K. & Gupta, Ravi. *Systematic Approach to Income Tax.* Bharat Law House.

Lakhotia, R. N. *Income Tax Planning Handbook.* Vision Books.

Singhania, V. K. & Singhania, Kapil. *Direct Taxes law & Practice.* Taxmann Publications.

Srinivas E. A. *Handbook of Corporate Tax Planning.* Tata McGraw Hill.

Online links

http://csgautam.org/2012/01/08/income-exempted-under-income-tax-act-sec-10/

http://en.wikipedia.org/wiki/Income_tax_in_India

http://law.incometaxindia.gov.in/Directtaxlaws/act2005/section10.htm

http://wircicai.org/wirc_referencer/Income%20Tax%20&%20Wealth%20Tax/Incomes%20Exempt%20From%20Tax.htm

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http://www.taxfaq.in/list-of-income-that-is-exempt-from-tax.html

Unit 5: Exemptions and Deductions – II

CONTENTS

Objectives

After studying this unit, you will be able to:

- Explain the Special provision in respect of newly established undertaking in FTZ's
- Discuss the Special provision in respect of newly established undertaking in SEZ's
- Describe the Special provision in respect of newly established undertaking in 100% EOUs

Introduction

Free Trade Zone, also called Foreign-trade Zone, formerly Free Port, an area within which goods may be landed, handled, manufactured or reconfigured, and re-exported without the intervention of the customs authorities.

Section 10AA was inserted in the Income-tax Act, 1961 by the Special Economic Zones Act, 2005 (the SEZ Act) with effect from 10-2-2006. The section was enacted specially with respect to provide tax exemption to the newly established units in the Special Economic Zone (SEZ).

The Export Oriented Unit (EOU) Scheme, which had been introduced in the early 1980s remains in the forefront of country's export production schemes. The Government amended in November

1983 a concession scheme to facilitate the setting up of export-oriented units (EOUs) in order to enable them to meet requirements of foreign demand in terms of pricing, quality, precision etc.

In this unit you will be able to gain in-depth knowledge about the tax provisions in respect of newly establish undertakings in FTZ, SEZ and 100% EOU in context with Income Tax Act, 1961.

5.1 Special Provisions in Respect of Newly Established Undertaking in FTZs

Free Trade Zone, also called Foreign-trade Zone, formerly Free Port, an area within which goods may be landed, handled, manufactured or reconfigured, and re-exported without the intervention of the customs authorities. Only when the goods are moved to consumers within the country in which the zone is located do they become subject to the prevailing customs duties.

Did u know? There are six free trade zones in India namely Kandla free trade zone, Santa Cruz Electronics Export processing zone, Falta Export processing Zone, Madras export processing zone, Cochin Export Processing zone and Noida Export Processing zone.

Subject to the provisions of this section, a deduction of such profits and gains as are derived by an undertaking from the export of articles or things or computer software for a period of ten consecutive assessment years beginning with the assessment year relevant to the previous year in which the undertaking begins to manufacture or produce such articles or things or computer software, as the case may be, shall be allowed from the total income of the assessee

Provided that where in computing the total income of the undertaking for any assessment year, its profits and gains had not been included by application of the provisions of this section as it stood immediately before its substitution by the Finance Act, 2000, the undertaking shall be entitled to deduction referred to in this sub-section only for the unexpired period of the aforesaid ten consecutive assessment years.

An undertaking initially located in any free trade zone or export processing zone is subsequently located in a special economic zone by reason of conversion of such free trade zone or export processing zone into a special economic zone, the period of ten consecutive assessment years referred to in this sub-section shall be reckoned from the assessment year relevant to the previous year in which the undertaking began to manufacture or produce such articles or things or computer software in such free trade zone or export processing zone.

For the assessment year beginning on the 1st day of April, 2003, the deduction under this sub-section shall be ninety per cent of the profits and gains derived by an undertaking from the export of such articles or things or computer software. Provided also that no deduction under this section shall be allowed to any undertaking for the assessment year beginning on the 1st day of April, 2012 and subsequent years.

Provided also that no deduction under this section shall be allowed to any undertaking for the assessment year beginning on the 1st day of April, 2012 and subsequent years.

5.1.1 Conditions to be Fulfilled

The tax benefit under section 10A is available to an undertaking which fulfils all the following conditions:

1. It has begun or begins to manufacture or produce articles or things or computer software during the previous year relevant to the assessment year.

(a) commencing on or after 1-4-1981, in any Free Trade Zone; or

(b) commencing on or after 1-4-1994, in any Electronic Hardware Technology Park or Software Technology Park; or

(c) commencing on or after 1-4-2001, in any Special Economic Zone;

2. It is not formed by the splitting up or the reconstruction of a business already in existence except in the circumstances and within the period specified in section 33B of the Income-tax Act.

3. It is not formed by the transfer to a new business of machinery or plant previously used for any purpose.

This section applies to the undertaking, if the sale proceeds of articles or things or computer software exported out of India are received in, or brought into, India by the assessee in convertible foreign exchange, within a period of six months from the end of the previous year or, within such further period as the competent authority may allow in this behalf.

5.1.2 Deductions

Notwithstanding anything contained in sub-section (1), the deduction, in computing the total income of an undertaking, which begins to manufacture or produce articles or things or computer software during the previous year relevant to any assessment year commencing on or after the 1st day of April, 2003, in any special economic zone, shall be:

(i) hundred per cent of profits and gains derived from the export of such articles or things or computer software for a period of five consecutive assessment years beginning with the assessment year relevant to the previous year in which the undertaking begins to manufacture or produce such articles or things or computer software, as the case may be, and thereafter, fifty per cent of such profits and gains for further two consecutive assessment years, and thereafter;

(ii) for the next three consecutive assessment years, so much of the amount not exceeding fifty per cent of the profit as is debited to the profit and loss account of the previous year in respect of which the deduction is to be allowed and credited to a reserve account (to be called the "Special Economic Zone Re-investment Allowance Reserve Account") to be created and utilised for the purposes of the business of the assessee in the manner laid down in sub-section (1B)

No deduction under this section shall be allowed to an assessee who does not furnish a return of his income on or before the due date specified under sub-section (1) of section 139.

The deduction under clause (ii) of sub-section (1A) shall be allowed only if the following conditions are fulfilled, namely:

(a) the amount credited to the Special Economic Zone Re-investment Allowance Reserve Account is to be utilised:

  (i) for the purposes of acquiring new machinery or plant which is first put to use before the expiry of a period of three years next following the previous year in which the reserve was created; and

  (ii) until the acquisition of new machinery or plant as aforesaid, for the purposes of the business of the undertaking other than for distribution by way of dividends or profits or for remittance outside India as profits or for the creation of any asset outside India;

(b) the particulars, as may be prescribed in this behalf, have been furnished by the assessee in respect of new machinery or plant along with the return of income for the assessment year relevant to the previous year in which such plant or machinery was first put to use.

Where any amount credited to the Special Economic Zone Re-investment Allowance Reserve Account under clause (ii) of sub-section (1A):

(a) has been utilised for any purpose other than those referred to in sub-section (1B), the amount so utilised; or

(b) has not been utilised before the expiry of the period specified in sub-clause (i) of clause (a) of sub-section (1B), the amount not so utilised, shall be deemed to be the profits,—

  (i) in a case referred to in clause (a), in the year in which the amount was so utilised; or

  (ii) in a case referred to in clause (b), in the year immediately following the period of three years specified in sub-clause (i) of clause (a) of sub-section (1B), and shall be charged to tax accordingly.

In computing the total income of the assessee of the previous year relevant to the assessment year immediately succeeds the last of the relevant assessment years, or of any previous year, relevant to any subsequent assessment year:

(i) Section 32, section 32A, section 33, section 35 and clause (ix) of sub-section (1) of section 36 shall apply as if every allowance or deduction referred to therein and relating to or allowable for any of the relevant assessment years 13[ending before the 1st day of April, 2001], in relation to any building, machinery, plant or furniture used for the purposes of the business of the undertaking in the previous year relevant to such assessment year or any expenditure incurred for the purposes of such business in such previous year had been given full effect to for that assessment year itself and accordingly sub-section (2) of section 32, clause (ii) of sub-section (3) of section 32A, clause (ii) of sub-section (2) of section 33, sub-section (4) of section 35 or the second proviso to clause (ix) of sub-section (1) of section 36, as the case may be, shall not apply in relation to any such allowance or deduction

(ii) No loss referred to in sub-section (1) of section 72 or sub-section (1) or sub-section (3) of section 74, in so far as such loss relates to the business of the undertaking, shall be carried forward or set off where such loss relates to any of the relevant assessment years 13[ending before the 1st day of April, 2001];

(iii) No deduction shall be allowed under section 80HH or section 80HHA or section 80-I or section 80-IA or section 80-IB in relation to the profits and gains of the undertaking; and

(iv) In computing the depreciation allowance under section 32, the written down value of any asset used for the purposes of the business of the undertaking shall be computed as if the assessee had claimed and been actually allowed the deduction in respect of depreciation for each of the relevant assessment year.

Notes For the purposes of this section:

1. Computer software means:

   a. Any computer programme recorded on any disc, tape, perforated media or other information storage device; or

   b. Any customized electronic data or any product or service of similar nature, as may be notified20 by the Board, which is transmitted or exported from India to any place outside India by any means

Contd...

2. Convertible foreign exchange means foreign exchange which is for the time being treated by the Reserve Bank of India as convertible foreign exchange for the purposes of the Foreign Exchange Regulation Act, 1973 (46 of 1973), and any rules made there under or any other corresponding law for the time being in force

3. Electronic hardware technology park means any park set up in accordance with the Electronic Hardware Technology Park (EHTP) Scheme notified by the Government of India in the Ministry of Commerce and Industry

4. Export turnover means the consideration in respect of export of articles or things or computer software received in, or brought into, India by the assessee in convertible foreign exchange in accordance with sub-section (3), but does not include freight, telecommunication charges or insurance attributable to the delivery of the articles or things or computer software outside India or expenses, if any, incurred in foreign exchange in providing the technical services outside India

5. Free trade zone means the Kandla Free Trade Zone and the Santacruz Electronics Export Processing Zone and includes any other free trade zone which the Central Government may, by notification in the Official Gazette, specify for the purposes of this section

6. Relevant assessment year means any assessment year falling within a period of ten consecutive assessment years referred to in this section

7. Software technology park means any park set up in accordance with the Software Technology Park Scheme notified by the Government of India in the Ministry of Commerce and Industry

8. Special economic zone means a zone which the Central Government may, by notification in the Official Gazette, specify as a special economic zone for the purposes of this section.

5.1.3 Consequences of Amalgamation, Demerger and Section 10A

Where any undertaking of an Indian company which is entitled to the deduction under this section is transferred, before the expiry of the period specified in this section, to another Indian company in a scheme of amalgamation or demerger:

(a) no deduction shall be admissible under this section to the amalgamating or the demerged company for the previous year in which the amalgamation or the demerger takes place; and

(b) the provisions of this section shall, as far as may be, apply to the amalgamated or the resulting company as they would have applied to the amalgamating or the demerged company if the amalgamation or demerger had not taken place.

Caselet

Nasscom for Tax Exemption under Section 10A or 10B

***N**ew Delhi:* As part of its budget recommendations to the government, National Association of Software and Services Companies (Nasscom) has reiterated its demand to retain the complete tax exemption under section 10A or 10B to the industry.

Contd...

Notes

"Government should honour the commitment of full exemption from taxes on export profits till 2010, since investments and business plans have been made on the basis of this commitment. We urge the government not to be short-sighted but look at long-term gains from this sector, which has contributed consistently to the growth of our economy," Nasscom president Kiran Karnik said. Nasscom has also suggested that the government should pursue the totalisation agreement with the US and tax withholding issue with Japan and other countries to help the Indian IT companies further expand in these markets. It has recommended tax holiday benefits as well as demergers and amalgamations to be excluded from the provisions of sections 10A/10B. Under custom-related issues, it has recommended that all taxable services provided in relation to software and services of online information, database access and data processing within banking and financial services, should be exempted from the levy of service tax. Within e-commerce, it has demanded that a tax moratorium on e-commerce at least for the next five years.

Source: http://www.financialexpress.com/news/nasscom-for-tax-exemption-under-section-10a10b/71143

Self Assessment

Fill in the blanks:

1. ……………………is an area within which goods may be landed, handled, manufactured or reconfigured, and re-exported without the intervention of the customs authorities.
2. For the assessment year beginning on the 1st day of April, 2003, the deduction under this sub-section shall be ………………of the profits and gains derived by an undertaking.
3. ………………deduction under this section shall be allowed to an assessee who does not furnish a return of his income on or before the due date specified under sub-section (1) of section 139.
4. ………….means any park set up in accordance with the Electronic Hardware Technology Park (EHTP) Scheme notified by the Government of India in the Ministry of Commerce and Industry.
5. ……………..means any park set up in accordance with the Software Technology Park Scheme notified by the Government of India in the Ministry of Commerce and Industry.

5.2 Special Provisions in Respect of Newly Established Undertaking in SEZs

Section 10AA was inserted in the Income-tax Act, 1961 by the Special Economic Zones Act, 2005 (the SEZ Act) with effect from 10-2-2006. The section was enacted specially with respect to provide tax exemption to the newly established units in the Special Economic Zone (SEZ).

5.2.1 Conditions to be Fulfilled

For claiming deduction under section 10AA of the Act following conditions are to be satisfied:

1. The assessee being an entrepreneur as defined under section 2(j) of the SEZ Act has to set up a unit in the SEZ
2. The unit so set up by the assessee should commence to manufacture or produce articles or things or provide any service during the previous year commencing after 1-4-2006

3. The undertaking should not be formed:

   (a) by splitting up, or by the reconstruction, of a business already in existence; or

   (b) by a transfer to new business of machinery and plant previously used for any purpose by the assessee;

4. The assessee has exported goods or provided services out of India from the SEZ, whether physically or otherwise

5. The books of account are audited and audit report is filed along with the return of income and the assessee claims the deduction in its return of income;

Subject to the provisions of the Section10AA(1), in computing the total income of an assessee, being an entrepreneur as referred to in clause (j) of section 228 of the Special Economic Zones Act, 2005, from his Unit, who begins to manufacture or produce articles or things or provide any services during the previous year relevant to any assessment year commencing on or after the 1st day of April, 2006, a deduction of:

(i) Hundred per cent of profits and gains derived from the export, of such articles or things or from services for a period of five consecutive assessment years beginning with the assessment year relevant to the previous year in which the Unit begins to manufacture or produce such articles or things or provide services, as the case may be, and fifty per cent of such profits and gains for further five assessment years and thereafter;

(ii) For the next five consecutive assessment years, so much of the amount not exceeding fifty per cent of the profit as is debited to the profit and loss account of the previous year in respect of which the deduction is to be allowed and credited to a reserve account (to be called the "Special Economic Zone Re-investment Reserve Account") to be created and utilized for the purposes of the business of the assessee in the manner laid down in sub-section (2).

The deduction under clause (ii) of sub-section (1) shall be allowed only if the following conditions are fulfilled, namely:

a. the amount credited to the Special Economic Zone Re-investment Reserve Account is to be utilised—

   (i) for the purposes of acquiring machinery or plant which is first put to use before the expiry of a period of three years following the previous year in which the reserve was created; and

   (ii) until the acquisition of the machinery or plant as aforesaid, for the purposes of the business of the undertaking other than for distribution by way of dividends or profits or for remittance outside India as profits or for the creation of any asset outside India;

b. the particulars, as may be specified by the Central Board of Direct Taxes in this behalf, under clause (b) of sub-section (1B) of section 10A have been furnished by the assessee in respect of machinery or plant along with the return of income29 for the assessment year relevant to the previous year in which such plant or machinery was first put to use.

Where any amount credited to the Special Economic Zone Re-investment Reserve Account under clause (ii) of sub-section (1): (a) has been utilised for any purpose other than those referred to in sub-section (2), the amount so utilised; or (b) has not been utilised before the expiry of the period specified in sub-clause (i) of clause (a) of sub-section (2), the amount not so utilised, shall be deemed to be the profits:

Notes

- in a case referred to in clause (a), in the year in which the amount was so utilised; or
- in a case referred to in clause (b), in the year immediately following the period of three years specified in sub-clause (i) of clause (a) of sub-section (2), and shall be charged to tax accordingly:

Provided that where in computing the total income of the Unit for any assessment year, its profits and gains had not been included by application of the provisions of sub-section (7B) of section 10A, the undertaking, being the Unit shall be entitled to deduction referred to in this sub-section only for the unexpired period of ten consecutive assessment years and thereafter it shall be eligible for deduction from income as provided in clause (ii) of sub-section (1).

Explanation: For the removal of doubts, it is hereby declared that an undertaking, being the Unit, which had already availed, before the commencement of the Special Economic Zones Act, 2005, the deductions referred to in section 10A for ten consecutive assessment years, such Unit shall not be eligible for deduction from income under this section:

Provided further that where a Unit initially located in any free trade zone or export processing zone is subsequently located in a Special Economic Zone by reason of conversion of such free trade zone or export processing zone into a Special Economic Zone, the period of ten consecutive assessment years referred to above shall be reckoned from the assessment year relevant to the previous year in which the Unit began to manufacture, or produce or process such articles or things or services in such free trade zone or export processing zone :

Provided also that where a Unit initially located in any free trade zone or export processing zone is subsequently located in a Special Economic Zone by reason of conversion of such free trade zone or export processing zone into a Special Economic Zone and has completed the period of ten consecutive assessment years referred to above, it shall not be eligible for deduction from income as provided in clause (ii) of sub-section (1) with effect from the 1st day of April, 2006.

This sub-section applies to any undertaking, being the Unit, which fulfils all the following conditions, namely:

(i) it has begun or begins to manufacture or produce articles or things or provide services during the previous year relevant to the assessment year commencing on or after the 1st day of April, 2006 in any Special Economic Zone;

(ii) it is not formed by the splitting up, or the reconstruction, of a business already in existence:

Provided that this condition shall not apply in respect of any undertaking, being the Unit, which is formed as a result of the re-establishment, reconstruction or revival by the assessee of the business of any such undertaking as is referred to in section 33B, in the circumstances and within the period specified in that section;

(iii) it is not formed by the transfer to a new business, of machinery or plant previously used for any purpose.

Explanation: The provisions of *Explanations 1* and *2* to sub-section (3) of section 80-IA shall apply for the purposes of clause (*iii*) of this sub-section as they apply for the purposes of clause (*ii*) of that sub-section.

Where any undertaking being the Unit which is entitled to the deduction under this section is transferred, before the expiry of the period specified in this section, to another undertaking, being the Unit in a scheme of amalgamation or demerger,

(a) no deduction shall be admissible under this section to the amalgamating or the demerged Unit, being the company for the previous year in which the amalgamation or the demerger takes place; and

Notes

(b) the provisions of this section shall, as they would have applied to the amalgamating or the demerged Unit being the company as if the amalgamation or demerger had not taken place.

Loss referred to in sub-section (1) of section 72 or sub-section (1) or sub-section (3) of section 74, in so far as such loss relates to the business of the undertaking, being the Unit shall be allowed to be carried forward or set off.

For the purposes of sub-section (1), the profits derived from the export of articles or things or services including computer software shall be the amount which bears to the profits of the business of the undertaking, being the Unit, the same proportion as the export turnover in respect of such articles or things or services bears to the total turnover of the business carried on:

Provided that the provisions of this sub-section shall have effect for the assessment year beginning on the 1st day of April, 2006 and subsequent assessment years. The provisions of sub-sections (5) and (6) of section 10A shall apply to the articles or things or services referred to in sub-section (1) as if:

(a) For the figures, letters and word "1st April, 2001", the figures, letters and word "1st April, 2006" had been substituted;

(b) For the word "undertaking", the words "undertaking, being the Unit" had been substituted.

The provisions of sub-section (8) and sub-section (10) of section 80-IA shall, so far as may be, apply in relation to the undertaking referred to in this section as they apply for the purposes of the undertaking referred to in section 80-IA.

Explanation 1: For the purposes of this section:

(i) "export turnover" means the consideration in respect of export by the undertaking, being the Unit of articles or things or services received in, or brought into, India by the assessee but does not include freight, telecommunication charges or insurance attributable to the delivery of the articles or things outside India or expenses, if any, incurred in foreign exchange in rendering of services (including computer software) outside India

(ii) "export in relation to the Special Economic Zones" means taking goods or providing services out of India from a Special Economic Zone by land, sea, air, or by any other mode, whether physical or otherwise

(iii) "manufacture" shall have the same meaning as assigned to it in clause (*r*) of section 2 of the Special Economic Zones Act, 2005

(iv) "relevant assessment year" means any assessment year falling within a period of fifteen consecutive assessment years referred to in this section

(v) "Special Economic Zone" and "Unit" shall have the same meanings as assigned to them under clauses (*za*) and (*zc*) of section 2 of the Special Economic Zones Act, 2005.

Explanation 2: For the removal of doubts, it is hereby declared that the profits and gains derived from on site development of computer software (including services for development of software) outside India shall be deemed to be the profits and gains derived from the export of computer software outside India.

Did u know? In order to remove this anomaly, the aforesaid provision of the sub-section (7) of section 10AA was amended by section 6 of the Finance (No. 2) Act, 2009, so as to substitute the reference to "assessee" by the word "undertaking". Accordingly, the exemption under section 10AA was to be computed with reference to the total turnover of the undertaking in the SEZ and not with reference to the total turnover of the business of the assessee. The said amendment made by Finance (No. 2) Act, 2009 become effective from 1-4-2010 and accordingly, applied in relation to the A.Y. 2010–11 and subsequent years. At the time when this amendment by the Finance (No. 2) Act, 2009 was made doubts were expressed as to whether the amendment should be retrospective or prospective from 2010–11 so as to streamline the provisions of the section.

5.2.2 Amount of Deduction: A Simplified Explanation

If the above conditions are satisfied, one can claim deduction under section 10AA. Deduction depends upon quantum of profit derived from export of articles or things or services (including computer software). It is calculated as under:

$$\text{Profits of the business of the Unit} \times \frac{\text{Export Turnover of the Unit}}{\text{Total Turnover of the business carried out by the assessee}}$$

Notes In the above formula 'export turnover' means the consideration in respect of export by the undertaking of articles or things or services received in, or brought into India by the assessee, but does not include the following:

a. freight

b. telecommunication charges;

c. insurance attributable to the delivery of the articles or things or computer software outside India;

d. expenses, if any, incurred in foreign exchange in providing the technical services (including computer software) outside India.

Profits and gains derived from on site development of computer software (including services for development of software) outside India shall be deemed to be the profits and gains derived from the export of computer software outside India.

This formula was seemingly created discrimination between assessee who were having multiple units in the SEZ as well as in the Domestic Tariff Area (DTA) and the assessee who were having units only in the SEZ. Here it may be pertinent to note that section 10AA itself clarified that the word, 'assessee' for the purpose of this section would mean an entrepreneur referred to in section 2(j) of the SEZ Act, as such the word, 'assessee' referred to in the formula should be an undertaking in the SEZ.

Deduction for First Five Assessment Years: 100 per cent of the profit and gains derived from export of articles or things or from services is deductible for a period of 5 consecutive assessment years. Deduction for the first year is available in the assessment year relevant to the previous year in which the unit begins to manufacture or produce articles or things or provide services.

Deduction for Sixth Assessment Year to Tenth Assessment Year: 50 per cent of the profit and gains derived from export of articles or things or from services is deductible for the next 5 years.

Deduction for Eleventh Assessment Year to Fifteenth Assessment Year: For the next 5 years, a further deduction would be available to the extent of 50 per cent of the profit provided an equivalent amount is debited to the profit and loss account of the previous year and credited to Special Economic Zone Re-investment Allowance Reserve Account (hereinafter referred to as Special Reserve Account). The following conditions should be satisfied:

1. The Special Reserve Account should be utilised for the purpose of acquiring new plant and machinery.
2. The new plant and machinery should be first put to use before the expiry of 3 years from the end of the year in which the Special Reserve Account was created. For instance, if the reserve account was created during the previous year ending March 31, 2007, it should be utilized for acquiring machinery or plant on or before March 31, 2010.
3. Until the acquisition of new plant and machinery the Special Reserve Account can be utilised for the business purposes of the undertaking but it cannot be utilised for distribution of dividends/profits or for remittance outside India as profits or for creating an asset outside India.
4. Prescribed particulars [Form No. 56FF] should be submitted in respect of new plant and machinery along with the return of income for the previous year in which such plant and machinery was first put to use.
5. If the Special Reserve Account is misutilised, then the deduction would be taken back in the year in which the Special Reserve Account is misutilised. If the Special Reserve Account is not utilised for acquiring new plant and machinery within three years as stated above then the deduction would be taken back in the year immediately following the period of three years. For instance, if ₹ 1,50,000 is transferred to the reserve account for the year ending March 31, 2007 and out of which only ₹ 96,000 is utilized for acquiring plant and machinery up to March 31, 2010, then ₹ 54,000 would be taxable for the previous year 2010–11.

Special Provisions for Existing Units

The following points should be noted:

1. In respect of an undertaking setup in Special Economic Zone on or after April 1, 2003 a deduction is available under section 10A(1A). This deduction is available for 10 assessment years. If an undertaking is setup in a Special Economic Zone during April 1, 2003 and March 31, 2005, then such undertaking can claim deduction for the first then assessment years under the provisions of section 10A(1A). Such undertaking can further claim deduction from eleventh year to fifteenth year.
2. If deduction has already been claimed by an undertaking (other than the undertaking mentioned above) under section 10A for ten consecutive assessment years before the commencement of SEZ Act, such Unit shall not be eligible for deduction under section 10AA.
3. Where a unit initially located in any free trade zone or export processing zone is subsequently located in a Special Economic Zone by reason of conversion of such free trade zone or export processing zone into a Special Economic Zone and has completed the period of 10 consecutive assessment years referred to above, it shall not be eligible for deduction.

Example: X Ltd. owns an industrial undertaking in a notified special economic zone. It starts manufacturing on April 10, 2004. It can claim deduction under sections 10A and 10AA as follows:

First 5 years: For the assessment years 2005–06 to 2009–10, it can claim 100 per cent deduction under section 10A.

Next 2 years: For the next two assessment years, i.e., 2010–11 and 2011–12, it can claim 50 per cent deduction under section 10A.

Next 3 years: For the next three assessment years, i.e., 2012–13 to 2014–15, it can claim 50 per cent deduction (subject to an additional requirement of transferring an equivalent amount to Special Economic Zone Re-investment Allowance Reserve Account) under section 10A.

Next 5 years: For the next five assessment years, i.e., 2015–16 to 2019–20, it can claim 50 per cent deduction (subject to an additional requirement of transferring an equivalent amount to Special Economic Zone Re-investment Reserve Account) under section 10AA (1)(ii).

Y Ltd. owns an industrial undertaking. It was set up in a notified free trade zone on June 10, 1991. It claims deduction under section 10A for 10 consecutive assessment years (i.e., 1992–93 to 2001–02). Since the undertaking has already claimed deduction for 10 years before the assessment year 2006–07, no further deduction is available for the same industrial undertaking under section 10AA. Suppose in the aforesaid case, the free trade zone is converted into a special economic zone with effect from January 1, 2001. The undertaking will get deduction under section 10A for 10 consecutive assessment years (i.e., 1992–93 to 2001–02). After claiming deduction for 10 years under section 10A (before the commencement of Special Economic Zone Act, 2005), no further deduction will be available for the same industrial undertaking under section 10AA.

5.2.3 Consequences for Amalgamation and Demerger

Where an undertaking is transferred to another company under a scheme of amalgamation or demerger, the deduction under section 10AA shall be allowable in the hands of the amalgamated or the resulting company. However, no deduction shall be admissible under this section to the amalgamating company or the demerged company for the previous year in which amalgamation or demerger takes place.

Consequences of Claiming Deduction under Section 10AA

One should note the following consequences:

- For the assessment year(s) succeeding the last assessment year for which the deduction is claimed under this section, deduction under section 32 and the expenditures under sections 35 and 36(1)(ix) pertaining to the assessment year 2005–06 (or earlier year) would be considered as had been given full effect to for the period covered under the period of deduction. Thus, unabsorbed depreciation allowances or unabsorbed capital expenditure on scientific research or family planning (pertaining to the assessment year 2005–06 or earlier years) are not allowed to be carried forward and set off against the income of assessment years following the period of deduction.
- The losses under section 72(1) or 74(1) or 74(3) (pertaining to the assessment year 2005–06 or earlier years) are not allowed to be carried forward in assessment years succeeding the period of deduction. The deductions under section 80-IA or 80-IB shall also not be available to such undertakings after the expiry of tax holiday period.
- In the assessment year following period of deduction, the depreciation will be computed on the written down value of the asset as if the depreciation has actually been allowed in respect of each assessment year falling in the period of exemption.

Exemption of capital gains on transfer of assets in cases of shifting of industrial undertaking from urban area to any Special Economic Zone:

Section 54GA has been inserted to give exemption in case of shifting of an industrial undertaking from urban area to a special economic zone. Exemption can be availed if the following conditions are satisfied –

1. A capital asset (being plant, machinery, land or building or any right in land or building) used for the purpose of an industrial undertaking situated in an urban area is transferred.

2. The transfer is affected in the course of, or in consequence of, the shifting of such industrial undertaking (hereinafter referred to as the "original asset") to any Special Economic Zone. Such Special Economic Zone may be situated in urban area of any other area.
3. The assessee has within a period of one year before or 3 years after the date on which the transfer took place:
   a. purchased machinery or plant for the purposes of business of the industrial undertaking in the Special Economic Zone to which the said undertaking is shifted;
   b. acquired building or land or constructed building for the purposes of his business in the Special Economic Zone;
   c. shifted the original asset and transferred the establishment to Special Economic Zone; and
   d. incurred expenses on such other purpose as may be specified in a scheme framed by the Central Government for the purposes of this section.

   If the above conditions are satisfied, then the amount of exemption is equal to:

   (i) the amount of capital gain generated on transfer of capital assets in the case of shifting of an industrial undertaking as stated above; or

   (ii) the cost and expenses incurred in relation to all or any of the purposes mentioned in (a) to (d) supra (such cost and expenses being hereinafter referred to as the new asset), whichever is lower.

Consequences if the New Asset is Transferred within 3 Years

If the new asset is transferred within a period of 3 years from the date of its purchase or construction or acquisition, the amount of exemption given earlier under section 54G would be taken back. In such a case, the capital gain on transfer of the new asset will be calculated as follows:

Particulars	₹
Sale consideration of the new asset	xxxxxx
Less: Cost of acquisition (original cost of acquisition of the new asset minus exemption given earlier under section 54GA which is going to be taken back because the new asset is transferred within 3 years)	xxxxxx
Short-term capital gain	xxxxxx

Deductions in respect of profits and gains by an undertaking or enterprise engaged in development of Special Economic Zone

Section 80-IAB has been inserted to give deduction to the developers of special economic zone. The following conditions should be satisfied –

1. The taxpayer is a developer of a special economic zone.
2. The gross total income of the taxpayer includes profits and gains derived by an undertaking from any business of developing a special economic zone.
3. Such special economic zone is notified on or after April 1, 2005.
4. The books of the account of the taxpayer are audited.

If the above conditions are satisfied, the taxpayer can claim 100 per cent deduction in respect of the aforesaid profit.

The aforesaid deduction is available for 10 consecutive assessment years. The deduction may be claimed, at the option of the taxpayer, for any 10 consecutive assessment years out of 15 years beginning from the year in which the special economic zone has been notified by the Central Government. If a taxpayer who develops a special economic zone on or after April 1, 2005 ("transferor") transfers the operation/maintenance of such zone to another developer ("transferee"), then deduction shall be allowed to the transferee for the remaining period of 10 years as if the operation and maintenance were not so transferred. Similar rule will be applicable in the case of amalgamation of an Indian company which has developed a special economic zone with another Indian company.

Caution One should also keep in view the following points–

1. The profits and gains from the eligible business shall be computed as if such eligible business were the only source of income of the assessee during the relevant assessment year.
2. The Assessing Officer has power to recompute profit in some cases. These cases are given by section 80-IA(8)/(10).
3. Where any amount of profits and gains is claimed and allowed as deduction under section 80-IAB for any assessment year, deduction to the extent of such profits and gains shall not be allowed under sections 80HH to 80RRB and shall in no case exceeds profits and gains of such eligible business.

Self Assessment

Fill in the blanks:

6. …………………was inserted in the Income-tax Act, 1961 by the Special Economic Zones Act, 2005 (the SEZ Act) with effect from 10-2-2006.
7. …………in relation to the Special Economic Zones means taking goods or providing services out of India from a Special Economic Zone by land, sea, air, or by any other mode, whether physical or otherwise.
8. In case of an SEZ deduction for first five assessment years is…………. of the profit and gains derived from export of articles or things or from services is deductible for a period of 5 consecutive assessment years.
9. In respect of an undertaking setup in Special Economic Zone on or after April 1, 2003 a deduction is available under ………………..
10. Where an undertaking is transferred to another company under a scheme of amalgamation or demerger, the deduction under section 10AA shall be allowable in the hands of the amalgamated or the …………………...

5.3 Special Provisions in Respect of Newly Established Undertakings in 100% Export Oriented Units (EOUs)

The Export Oriented Unit (EOU) Scheme, which had been introduced in the early 1980s remains in the forefront of country's export production schemes. The Government amended in November 1983 a concession scheme to facilitate the setting up of Export Oriented Units (EOUs) in order to enable them to meet requirements of foreign demand in terms of pricing, quality, precision etc.

The main objectives of the EOU scheme is to increase exports, earn foreign exchange to the country, transfer of latest technologies stimulate direct foreign investment and to generate additional employment. The scheme has witnessed many changes over the last twenty-four years in the context of ever changing economic realities. However, the basic premise remains the same. This premise is that the exporters are treated as a special class and given the required tariff, non-tariff and policy support to facilitate their export efforts. Thus, today the EOU Scheme has emerged as a dynamic policy initiative facilitating the exporting community in the task of increased exports. The EXIM Policy, 2002–07 reinforces the importance of Scheme in chapter 6 of the policy.

Did u know? **Need for Special License**

To set up an EOU for the following sectors, an EOU owner needs a special license.

1. Arms and ammunition,
2. Explosives and allied items of defence equipment,
3. Defence aircraft and warships,
4. Atomic substances,
5. Narcotics and psychotropic substances and hazardous chemicals,
6. Distillation and brewing of alcoholic drinks,
7. Cigarettes/cigars and manufactured tobacco substitutes.

In the above mention cases, EOU owner are required to submit the application form to the Development Commissioner who will then put them up to the Board of Approvals (BOA).

Major Sectors in EOUs

The following is the list of major sectors in EOUs:

- Granite
- Textiles/garments
- Food processing
- Chemicals
- Computer software
- Coffee
- Pharmaceuticals
- Gem & jewellery
- Engineering goods
- Electrical & electronics
- Aqua & pearl culture

Categories of 100% EOUs

The 100% EOUs fall into three categories:

(a) EOUs established anywhere in India and exporting 100% products except certain fixed percentage of sales in the Domestic Tariff Area (DTA) as may be permissible under the Policy.

Notes

(b) Units in Free Trade Zones in Special Economic Zones (SEZs) and exporting 100% of their products.

(c) EOUs set up in Software Technology Parks (STPs) and Electronic Hardware Technology Parks (EHTPs) of India for development of Software & Electronic Hardware.

5.3.1 Conditions to be Fulfilled

A 100 per cent export-oriented unit is an industrial unit offering for export its entire production, excluding the permitted levels of domestic tariff area sales. EOUs may be set up with a foreign equity participation of up to 100 per cent. For setting up a 100 per cent EOU the following conditions are applicable:

(i) The entire production and operation of 100 per cent EOUs must be in a customs bonded factory, unless specifically exempt from physical bonding; Goods will be imported into the customs bonded factory.

(ii) The unit shall undertake to manufacture in the bonded area and to export its entire production for a period of 10 years ordinarily and 5 years in case of products liable to rapid technological change.

Did u know? Regarding the export obligations of 100 per cent EOUs, the following conditions apply:

1. EOUs need not export their manufactured goods themselves but may use an export house/trading house/star trading house or other EOUs subject to certain conditions;

2. EOUs may execute export orders also through third parties given that the goods will be directly transferred from the customs bonded factory to the port of shipment and all export benefits will be to EOUs only.

(iii) An approved EOU will execute a bond/legal undertaking with the Development Commissioner concerned; Failure to fulfil the obligations stipulated in the letter of approval or intent will render the unit liable to penalty.

(iv) EOUs have to adhere to the minimum value addition conditions incorporated in the letter of permission/letter of intent/industrial license issued to them; In general, such minimum value addition will be 35 per cent for automatic approvals and 20 per cent for other cases.

(v) EOUs have to maintain a proper account of the imports, consumption and utilization of all imported materials and exports made by the unit; These accounts will be submitted periodically to the Development Commissioner. Wherever an existing industrial unit is operating both as a domestic unit as well as an approved 100 per cent EOU, it should have two distinct identities with separate accounts.

(vi) EOUs are permitted to sell part of the production in the domestic tariff area subject to certain limits.

(vii) The f.o.b. value of exports of an EOU can be clubbed with the f.o.b. value of exports of its parent company in the domestic tariff area to attain export house, trading house or star trading house status for the parent company.

(viii) Supplies produced in the domestic tariff area under global tender conditions, against payment in foreign exchange, against advance licenses and other import licenses, and to other EOUs with the permission of the Development Commissioner, will be counted towards the fulfilment of export obligations.

Notes On completion of the bonding period, it shall be open to the unit to continue under the scheme or to opt out of the scheme. Debonding will, however, be subject to the industrial policy in force at the time the option is exercised. Where debonding is sought before the stipulated export obligation period of 5 to 10 years, or where EOUs are unable to fulfil their export commitments out of various reasons, it is considered premature debonding. This is subject to payment of all leviable duties without the benefit of depreciation, and also subject to penalties and other conditions as decided by the Board of Approvals for 100 per cent EOUs.

Caution Customs duties on capital goods as well as customs duties on unused raw materials, components, consumables and spares are leviable on debonding after the export period.

5.3.2 Deductions

Section 10-B of the Income-tax Act provides for 100% deduction of profits derived by a hundred by a hundred per cent Export Oriented undertaking, form export of articles or things or computer software manufactured or produced by it. The deduction is available for a period of ten consecutive assessment years beginning with the assessment year relevant to the previous year in which the undertaking begins to manufacture or produce articles or things or computer software. However, no deduction under section 10-B is available after assessment year 2009–10. The deduction u/s 10-B is available to an undertaking which fulfils and the following conditions:

(i) it manufacturers or produces any article or thing or commuter software;

(ii) it is not formed by the splitting up, or the reconstruction, of a business already in existence except in the circumstances specified under section 33B or the IT Act.

(iii) it is not formed, by the transfer to a new business of machinery or plant previously used for any purpose.

Representations have been received from various quarters as to whether an undertaking set up in Domestic tariff Area, which is subsequently approved as 100% EOU by the Board appointed by the Central Government in exercise of powers conferred under section 14 of the Industries (Development and Regulation) Act, 1951, is eligible for deduction u/s. 10B of the Income-tax Act.

The matter has been examined and it is hereby clarified that an undertaking set up in domestic Tariff Area (DTA) and deriving profit from export of articles or things or computer software manufactured or produced by it, which is subsequently converted into EOU, shall be eligible for deduction u/s. 10B of the IT Act, on getting approval as 100% export oriented undertaking. In such a case, the deduction shall be available only from the year in which it has got the approval as 100% EOU and shall be available only for the remaining period of ten consecutive assessment years, beginning with the assessment year relevant to the previous year in which the undertaking begins to manufacture or produce articles or things or computer software, as a DTA unit. Further, in the year of approval, the deduction shall be restricted to the profits derived from exports, from and after the date of approval of the DTA Unit as 100% EOU. Moreover, the deduction to such units in any case will not be available after assessment year 2009–10.

Example: To clarify the above position, certain illustrations are given as under:

(i) Undertaking 'A' is set up in domestic Tariff Area and starts manufacture or production of computer software in Financial Year 1999–2000 relevant to assessment year 2000–01. It gets approval as 100% EOU on 10th September, 2004 in the Financial Year 2004–05 relevant to assessment year 2005–06. Accordingly, it shall be eligible for deduction under section 10B from assessment year 2005–06 i.e., the year in which it fulfils the basic condition of being a 100% EOU. Further, the deduction shall be available only for the remaining period of ten years i.e. from AY. 2005–06 to A.Y. 2009–10. This deduction under section 10B for A.Y. 2005–06 shall be restricted to the profits derived from exports, from and after the date of approval of the DTA unit as 100% EOU.

(ii) Undertaking 'B' set up in Domestic Tariff Area, begins to manufacture or produce computer software in financial year 96–97 relevant to assessment year 1997–98. It gets approval as 100% EOU in Financial year 2007–08 relevant to assessment year 2008–09. No deduction under section 10B shall be admissible to undertaking B as the period of 10 years expires in F.Y. 2005–06 relevant to A.Y. 2006–07 prior to its approval as 100% EOU.

(iii) Undertaking 'C' is set up in Domestic Tariff Area in the financial year 2000–01 relevant to assessment year 2001–02 and engaged in the business of providing computer related services, other than those notified by the Board for the purpose of section 10B. In financial year 2002–2003, it acquires more than 20% of old plant & machinery and starts manufacturing computer software. It also gets approval as 100% EOU in financial year 2002–03. Undertaking 'C' shall not be eligible for deduction under section 10B, as there has been transfer of old plant and machinery.

(iv) Undertaking 'D' is set up and starts producing computer software in Financial year 2003–04 relevant to AY 2004–05. It gets approval as 100% EOU in FY 2006–07 relevant to AY 2007–08. It shall be eligible for deduction u/s. 10B from AY 2007–08. However, the deduction shall not be available after AY 2009–10.

(v) Undertaking 'E' is set up and starts producing computer software prior to 31.3.1994. It gets approval as 100% EOU in FY 2004–05 relevant to AY 2005–06. Undertaking 'E' shall not be eligible for deduction u/s. 10B as the period of deduction of 10 years expires prior to A.Y. 2005–06.

5.3.3 Consequences for Amalgamation and Demerger

Where any undertaking of an Indian company which is entitled to the deduction under this section is transferred, before the expiry of the period specified in this section, to another Indian company in a scheme of amalgamation or demerger:

(i) ***Amalgamating or the Demerged company:*** No deduction shall be admissible under this section to the amalgamating or the demerged company for the previous year in which the amalgamation or the demerger takes place; and

(ii) ***Amalgamated or the Resulting company:*** Deduction shall be admissible under this section to the amalgamated or the resulting company for the unexpired period of deduction.

Self Assessment

Fill in the blanks:

11. The Government amended in November 1983 a concession scheme to facilitate the setting up of ………………in order to enable them to meet requirements of foreign demand in terms of pricing, quality, precision etc.

Notes

12. The EXIM Policy, 2002–07 reinforces the importance of Scheme in ……………of the policy.
13. EOUs established anywhere in India and exporting 100% products except certain fixed percentage of sales in the ……………….as may be permissible under the Policy.
14. …………of the Income-tax Act provides for 100% deduction of profits derived by a hundred by a hundred per cent Export Oriented undertaking, form export of articles or things or computer software manufactured or produced by it.
15. ………………deduction shall be admissible under this section to the amalgamating or the demerged company for the previous year in which the amalgamation or the demerger takes place.

Case Study

Tata Infotech Limited, Mumbai vs Assistant Commissioner of Income Tax

This is an appeal filed by the assessee against the order passed by the Commissioner of Income Tax under section 263 of the Income Tax Act, 1961, on 31.03.2008.

The appeal relates to the assessment year 2003–04. The assessment of the assessee was completed by the Assessing Officer on a total income of ₹8,36,338/-. In the return the assessee had claimed deduction under section 10A in respect of income arising from the industrial undertakings located at the Electronic Hardware Technology Park (EHTP) at Goa and the Software Technology Parks (STP) situated at Pune, Bangalore and Chennai. Under the section, as it stood at the relevant time, the assessee was entitled to the deduction of 90% of the profits of the above 2 ITA No: 4324/Mum/2008 undertakings. The assessee claimed deduction of 90% of the profits in the following manner:

EHTP - Goa ₹10,78,39,621/- STP - Pune ₹16,69,51,092/- STP - Bangalore ₹ 7,76,04,345/- STP - Chennai ₹ (-)1,06,428/ and the total coming as ₹35,22,88,630/-.

In support of the above claim for deduction, detailed computations in respect of each undertaking were submitted along with the return. In the statement of income from profits and gains of the business, the assessee started the computation of the income from the profit figure shown in the Profit and Loss Account and reduced therefrom the figure of ₹35,22,88,630/-. The ultimate income shown in the computation was a loss of ₹2,96, 39,052. In the assessment order passed under section 143(3), the Assessing Officer also started the computation from the figure of net profit as per the Profit and Loss Account, as was done by the assessee and deducted ₹32,15,58,051/- under section 10A. However, there was one change. Due to slight changes in the computation of the profits of each of the undertakings, there was a change also in the figure of 90% of the profits of the undertakings. As per the computation in the assessment order, the figure of 90% of the profits of the Goa unit came to ₹9,97,95,226/- as against the figure of ₹10,78,39,621/- as per the assessee's computation. There were similar changes in respect of the Pune and Bangalore units also. The result was as against the deduction of ₹35,22, 88,630/- claimed by the assessee 3 ITA No: 4324/Mum/ 2008 under section 10A, the Assessing Officer allowed deduction of ₹32,15,58,051/-. The Assessing Officer determined the taxable income of the assessee at ₹8,36,338/-.

On 18.03.2008 the CIT issued notice to the assessee proposing to revise the assessment under section 263 of the Act. According to him, the Assessing Officer ought to have assessed the difference of ₹3,07,30,529/- between the claim of ₹35,22,88,630/- made by the assessee

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under section 10A and ₹32,15,58,051/- allowed by the Assessing Officer in the assessment order. Since this was not done, there has been an escapement of income to the extent of ₹2,98,94,191/-, which is the difference between ₹3,07,30,529/- and ₹8,36,338/-. According to the CIT the losses of the local units not eligible for deduction under section 10A, amounting to ₹2,96,94,241/- was adjusted against the 10% of the profits of the units enjoying deduction under section 10A, which were to be brought to tax. The CIT also observed in the notice that the assessee has been allowed deduction of ₹9,37,546/- under Chapter VI-A which was not allowable in view of the loss from the non 10A units and this has also resulted in short levy of tax.

The assessee objected to the notice and submitted that there was nothing in section 10A which prohibits the setting off of the 10% of the taxable profits of the units eligible for the benefit under section 10A against the loss of the local units which do not enjoy any benefit under section 10A of the Act. It was pointed out that once the 10% of the profits of the units enjoying the benefit of section 10A are taxed as profits and gains of the business, the 4 ITA No: 4324/Mum/2008 provisions relating to set off of losses from other sources under the same head and under other heads of income, as provided in sections 70 and 71 of the Act, automatically come into play. In support of these submissions the assessee relied on the order of the Mumbai Bench of the Tribunal in Navin Bharat Industries Ltd. vs. DCIT (2004) 90 ITD 1 (Mum) (TM) and the Bangalore Bench of the Tribunal in Mindtree Consulting Pvt. Ltd. vs. ACIT (2006) 102 TTJ (Bang) 691. It was thus pleaded that the assessment order was neither erroneous nor prejudicial to the interests of the revenue.

The CIT did not accept the assessee's submissions. According to him the 10% of the profits of the section 10A undertakings have to be set apart and separately considered and brought to tax and cannot be utilized to be adjusted against the losses under the same head or under other heads of income. He held that the profits computed under section 10A have to be given separate treatment and cannot be merged with the profits computed under the remaining provisions of the Act. Section 10A, he opined, was a self-contained code and none of the other provisions of the Act will apply.

He also held that the income computed under section 10A will not constitute part of the gross total income as defined under section 80B against which alone deductions under Chapter VI-A are allowed. In addition to this line of reasoning, the CIT also held that the orders of the Mumbai and Bangalore Benches of the Tribunal were not applicable and that he was in respectful disagreement with those orders. In this view of the 5 ITA No: 4324/ Mum/2008 matter, he directed the Assessing Officer to compute the total income of section 10A undertakings separately without allowing any set off of loss or unabsorbed depreciation in respect of the non 10A units. He also held that since there was a loss in the non 10A units, the deductions under sections 80G and 80-O were incorrectly allowed against the income from section 10A units. He thus directed the Assessing Officer to pass a fresh assessment order after giving the assessee proper opportunity.

The assessee is in further appeal before the Tribunal to contend that the assessment order was neither erroneous nor prejudicial to the interests of the revenue inasmuch as it was in conformity with the views expressed in several orders of the Tribunal. It was submitted that where the assessment order is in accordance with the views expressed by a higher judicial forum, it cannot be termed to be erroneous. It was argued that in any case the matter raised several legal questions and was highly debatable and just because the Assessing Officer adopted one of the possible legal interpretations of the provisions of the statute it does not follow that his order is erroneous. Our attention was drawn to several orders of different Benches of the Tribunal in which the view was taken that the 10% profits of the section 10A unit which are brought to tax for the assessment year 2003–04 can

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be utilized for being adjusted against the brought forward losses and the losses for the same year either under the same head of income but from a different source or under another head of income for the same year. 6 ITA No: 4324/Mum/2008. It was thus submitted that the order under section 263 was bad in law.

The learned CIT Departmental Representative strongly relied on the order passed by the CIT and the reasoning given therein. She further submitted that the assessment order was contrary to the provisions of the statute and, therefore, was rightly held to be erroneous by the CIT. It was her contention that the 10% profits which are taxed under section 10A for the assessment year 2003–04 cannot be utilized for being adjusted against losses for the same year under different sources or heads of income or against brought forward losses. She submitted that such profits stand on a separate footing and cannot be considered to be part of the profits and gains of the business as computed under sections 29 to 43 of the Act.

On a careful consideration of the rival contentions, we are of the view that the assessment order cannot be said to be erroneous since it is in accordance with the views expressed in several orders of different Benches of the Tribunal. In the case of Mindtree Consulting Pvt. Ltd. (supra), it was held that the profits which became taxable after availing of the exemption under section 10B of the Act were available to be adjusted against the loss assessed for the same year under the head "Income from other sources" as permitted under section 71.

It may be clarified that section 10B is substantially similar to section 10A of the Act. In the case of Navin Bharat Industries Ltd. (supra), the Mumbai Bench of the Tribunal held that the units under section 10A are entitled to set off their 7 ITA No: 4324/Mum/2008 losses against the profits from non 10A units or against other business income for the same year. This order deals with the reverse situation. However, the question is whether the provisions of sections 70 and 71 are applicable even with regard to the losses or profits assessed in respect of units enjoying the benefits of section 10A.

That question was decided by the Tribunal by holding in the affirmative. In Wipro BPO Solutions Ltd. vs. DCIT [2010- TIOL-95-ITAT-BANG], the Bangalore Bench of the Tribunal was dealing with section 10B. After noting that 90% of the profits were deductible under the section and 10% of the profits were assessable for the assessment year 2003–04, it was held that the business loss brought forward from the assessment year 2001–02 can be set off against the 10% profits assessed under section 10B for the assessment year 2003–04. In DCIT vs. A V Thomas Leather & Allied Products Ltd. [2009-TIOL-434-ITAT-MAD], the Chennai Bench of the Tribunal held that the loss in respect of a unit under section 10A can be set off against the profit earned for the same year by the non 10A units. In the case of Honeywell International India () Ltd. vs. DCIT (2007) 108 TTJ (Del) 924, the Delhi Bench of the Tribunal was dealing with the loss of an unit eligible under section 10A for the assessment year 2003–04. It was held that the loss can be set off against the profits of any other unit or business under sections 70 and 71 of the Act. Again the Mumbai Bench of the Tribunal in the case of Sovika Infotek Ltd. vs. ITO [2008-TIOL- 343-ITAT-MUM], dealing with section 10B, held that the provisions of sections 70 and 71 were applicable and the loss from the 10A 8 ITA No: 4324/Mum/2008 unit can be adjusted against the income from other sources for the same year.

Thus there is ample authority in the form of orders of different Benches of the Tribunal for the proposition that the 10% profits of an unit under section 10A which is assessed for the assessment year 2003–04 are not different in any way from the profits of any other business carried on by the assessee and, therefore, any losses for the same year or brought forward from an earlier year can be adjusted against those profits. The loss arising in the section 10A unit is also eligible for being adjusted against the profits of any other business for the same year or against income under other heads of income.

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As against this view adumbrated in the orders of the Tribunal, in accordance with which the assessment order in the present case has been framed, the CIT has taken a different view. We are not here concerned with the correctness of either of the views. It is only to be noted that where the assessment order has been passed on the basis of one of the several plausible views or interpretations to be placed on the statutory provisions, it does not become erroneous and prejudicial to the interests of the revenue merely because the CIT prefers to adopt another view which is favourable from the Revenue's point of view.

This is a well settled position for which no authority needs to be cited. In this view of the matter, we hold that the Assessing Officer did not err and the assessment order passed by him cannot be said to be erroneous because the 10% profits of the units eligible for the benefit under section 10A have been used to adjust the 9 ITA No: 4324/Mum/2008 losses from the local non 10A units. The appeal of the assessee is accordingly accepted and the order of the CIT passed under section 263 is set aside.

Questions

1. Study and analyse the case.
2. Write down the case facts.
3. What do you infer from it?

Source: *http://www.indiankanoon.org/doc/41007109/*

5.4 Summary

- Free Trade Zone, also called Foreign-trade Zone, formerly Free Port, an area within which goods may be landed, handled, manufactured or reconfigured, and re-exported without the intervention of the customs authorities.
- No deduction under this section shall be allowed to an assessee who does not furnish a return of his income on or before the due date specified under sub-section (1) of section 139.
- Where any undertaking of an Indian company which is entitled to the deduction under this section is transferred, before the expiry of the period specified in this section, to another Indian company in a scheme of amalgamation or demerger.
- Section 10AA was inserted in the Income-tax Act, 1961 by the Special Economic Zones Act, 2005 (the SEZ Act) with effect from 10-2-2006.
- Where an undertaking is transferred to another company under a scheme of amalgamation or demerger, the deduction under section 10AA shall be allowable in the hands of the amalgamated or the resulting company.
- Section 54GA has been inserted to give exemption in case of shifting of an industrial undertaking from urban area to a special economic zone.
- The Export Oriented Unit (EOU) Scheme, which had been introduced in the early 1980s remains in the forefront of country's export production schemes.
- The main objectives of the EOU scheme is to increase exports, earn foreign exchange to the country, transfer of latest technologies stimulate direct foreign investment and to generate additional employment.
- A 100 per cent export-oriented unit is an industrial unit offering for export its entire production, excluding the permitted levels of domestic tariff area sales.
- EOUs may be set up with a foreign equity participation of up to 100 per cent.

5.5 Keywords

Amalgamation: An amalgamation is distinct from a merger because neither of the combining companies survives as a legal entity.

Assessment Years: Assessment year means the current year.

Convertible Foreign Exchange: It means foreign exchange which is for the time being treated by the Reserve Bank of India as convertible foreign exchange for the purposes of the Foreign Exchange Regulation Act, 1973 (46 of 1973), and any rules made there under or any other corresponding law for the time being in force.

Deductions: An expense subtracted from adjusted gross income when calculating taxable income, such as for state and local taxes paid, charitable gifts, and certain types of interest payments.

Demerger: Demerger is a form of corporate restructuring in which the entity's business operations are segregated into one or more components.

Electronic Hardware Technology Park: It means any park set up in accordance with the Electronic Hardware Technology Park (EHTP) Scheme notified21 by the Government of India in the Ministry of Commerce and Industry.

Export Turnover: Export turnover means the consideration in respect of export of articles or things or computer software received in, or brought into, India by the assessee in convertible foreign exchange in accordance with sub-section (3), but does not include freight, telecommunication charges or insurance attributable to the delivery of the articles or things or computer software outside India or expenses, if any, incurred in foreign exchange in providing the technical services outside India.

Free Trade Zone: A free trade zone (FTZ) or export processing zone (EPZ), also called foreign-trade zone, formerly free port is an area within which goods may be landed, handled, manufactured or reconfigured, and re-exported without the intervention of the customs authorities.

Relevant assessment year: It means any assessment year falling within a period of ten consecutive assessment years referred to in this section.

Software Technology Park: It means any park set up in accordance with the Software Technology Park Scheme notified by the Government of India in the Ministry of Commerce and Industry.

Special Economic Zone: It means a zone which the Central Government may, by notification in the Official Gazette, specify as a special economic zone for the purposes of this section.

Tax Benefit: A tax benefit is an allowable deduction on a tax return intended to reduce a taxpayer's burden while typically supporting certain types of commercial activity.

5.6 Review Questions

1. Discuss Free Trade Zone.
2. What are the conditions to be fulfilled in Free Trade Zone?
3. Throw some light on the deductions of Free Trade Zone.
4. Describe the consequences of amalgamation and demerger of Free Trade Zone.
5. Elucidate the conditions to be fulfilled under Special Economic Zone.
6. Describe the amount of deduction in Special Economic Zone.
7. Highlight the consequences for amalgamation and demerger of Special Economic Zone.

8. What are the 100% Export Oriented Unit (EOU)?
9. Describe the categories of 100% EOUs.
10. Discuss the deduction part of 100% EOUs.

Answers: Self Assessment

1. Free Trade Zone
2. Ninety per cent
3. No
4. Electronic hardware technology park
5. Software technology park
6. Section 10AA
7. Export
8. 100 per cent
9. Section 10A(1A)
10. Resulting company
11. Export-oriented units (EOUs)
12. Chapter 6
13. Domestic Tariff Area (DTA)
14. Section 10-B
15. No

5.7 Further Readings

Books

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Unit 6: Deductions: For Special Conditions

CONTENTS

Objectives

After studying this unit, you will be able to:

- State the meaning SEZ
- Discuss the key tax benefits to be provided to SEZs and SEZ Units
- Realise the deduction in respect of profits and gains by an undertaking or enterprise engaged in development of SEZ
- Trace the special provisions in respect of certain undertakings or enterprises in certain special category States
- Elucidate tax holiday in respect of profits and gains from eligible business of certain undertakings in North-Eastern States
- Test Application of the above Special Conditions

Introduction

A Special Economic Zone (SEZ) is a specified, delineated and duty-free geographical region that has different economic laws from those of the country in which it is situated. In some countries, such a region is even treated as a deemed foreign territory. Therefore you can say that SEZs are free trade zones, having completely different set of administrative and taxation laws outside the purview of customs authorities. Traditionally SEZs are created as open markets within an economy that is dominated by distortional trade, macro and exchange regulations and other regulatory governmental controls. SEZs are believed to create conducive environment to promote investment and exports. Hence, many developing countries are developing SEZs with the expectation that they will provide the engines of growth for their economies to achieve industrialization.

The Special Economic Zones and Tax Incentives offered as per the SEZ policy of India are indeed alluring. The Special Economic Zones and Tax Incentives offered covers areas like state and local taxes, levies, stamp duty and other duties. As per the Income-tax Act, 1961 there are a number of key tax benefits to be provided to SEZs and SEZ Units.

All the Special Economic Zones function under the guardianship and the jurisdiction of the Commerce Ministry, Government of India. The relevant or applicable exemptions and incentives as offered for the operation of the Special Economic Zones are provided in the Special Economic Zone Act of India. These exemptions on income taxes are detailed in the Second Schedule to the SEZ Act. Section 27 of the SEZ Act provides -

- Provisions of Income tax Act;
- As in force for time being;
- Shall apply to developer or entrepreneur;
- For carrying on authorized operations in an SEZ or Unit;
- Subject to modifications specified in Second Schedule;

6.1 Key Tax Benefits for SEZs and SEZ Units

Section 80-IA(1) provides a ten year tax holiday to an assessee, whose gross total income includes any profits and gains derived by an undertaking or enterprise from an eligible business i.e., business referred to in sub-section (4), namely :

(1) ***Infrastructure facility:*** Any enterprise carrying on the business of:

  a. developing

  b. operating and maintaining; or

  c. developing, operating and maintaining any infrastructure facility.

  Conditions: However, such enterprise must fulfil the following conditions:

  (i) It must be owned by a company registered in India or by a consortium of such companies or by an authority or a board or a corporation or any other body established or constituted under any Central or State Act.

  (ii) It has entered into an agreement with the Central or a State Government or a local authority or statutory body for:

   ♦ developing or

   ♦ operating and maintaining, or

   ♦ developing, operating and maintaining a new infrastructure facility.

  (iii) It starts operating and maintaining such infrastructure facility on or after 1-4-1995.

  (iv) However, where an enterprise which developed such infrastructure facility transfers it to another enterprise on or after 1-4-1999, and such transferee enterprise operates and maintains it according to the agreement drawn up with the Government, etc.; this section will apply to the transferee enterprise for the unexpired period of deduction (which was available to the first enterprise).

  Meaning of "infrastructure facility": For this purpose, 'infrastructure facility' means:

  (i) a road, including toll road, a bridge or a rail system

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(ii) a highway project including housing or other activities being an integral part of the highway project;

(iii) a water supply project, water treatment system, irrigation project, sanitation and sewerage system or solid waste management system; and

(iv) a port, airport, inland waterway or inland port or navigational channel in the sea.

Notes

1. Structures at the ports for storage, loading and unloading etc. will be included in the definition of port for the purpose of section 80-IA, if the concerned port authority has issued a certificate that the said structures form part of the port.

2. Effluent treatment and conveyance system is a part of water treatment system and would accordingly, qualify as an infrastructure facility for the purpose of section 80-IA.

3. The CBDT has, vide ***Circular No. 4/2010 dated 18.5.2010***, clarified that widening of an existing road by constructing additional lanes as a part of a highway project by an undertaking would be regarded as a new infrastructure facility for the purpose of section 80-IA(4)(i). However, simply relaying of an existing road would not be classifiable as a new infrastructure facility for this purpose.

(2) ***Telecommunication undertakings:*** Any undertaking providing telecommunication services, whether basic or cellular, including radio paging, domestic satellite service or network of trunking (NOT), broadband network and internet services on or after 1 April, 1995 but on or before 31 March, 2005.

Meaning of "domestic satellite": 'Domestic satellite' has been defined by sub-section (12)(a) as "a satellite owned and operated by an Indian company for providing telecommunication services."

(3) ***Industrial parks or Special Economic Zones:*** Any undertaking which develops, develops and operates, or maintains and operates an industrial park or develops, or develops and operates, or maintains and operates, a special economic zone.

Conditions:

(i) The undertaking begins to operate an industrial park or special economic zone in accordance with the scheme framed and notified by the Central Government.

(ii) The scheme is notified by the Government for the period beginning on 1-4-1997 and ending on 31-3-2011 for industrial parks and 31.3.2006 for SEZs.

Rule 18C lays down the following eligibility criteria for Industrial Parks to claim benefit under section 80-IA (4) (iii) -

1. The undertaking should begin to develop, develop and operate or maintain and operate an industrial park any time during the period from 1.4.2006 to 31.3.2009.

2. The undertaking and the Industrial Park should be notified by the Central Government under the Industrial Park Scheme, 2008.

3. The undertaking should continue to fulfil the conditions envisaged in the Industrial Park Scheme, 2008.

(iii) However, where an undertaking develops an industrial park on or after 1.4.1999 or a special economic zone on or after 1.4.2001 and transfers the operation and maintenance to another undertaking (transferee undertaking), the deduction to the transferee undertaking shall be available for the remaining period in the ten consecutive assessment years, in such a manner as would have been available to the transferor undertaking, as if the operation and maintenance were not so transferred to the transferee undertaking.

(4) ***Power undertakings:*** Any undertaking which

(i) Is set up in any part of India for the generation or generation and distribution of power. However, such undertaking must begin to generate power at any time during the period between 1.4.1993 and 31.3.2013.

(ii) Starts transmission or distribution by laying a network of new transmission or distribution lines at any time during the period from 1.4.1999 and 31.3.2013. However, the deduction shall be allowed only in respect of profits derived from the laying of such network of new lines for transmission or distribution.

(iii) Undertakes substantial renovation and modernisation of the existing network of transmission or distribution lines at any time during the period beginning on 1.4.2004 and ending on 31.3.2013.

Substantial renovation and modernisation means an increase in the plant and machinery in the network of transmission or distribution lines by at least fifty per cent of the book value of such plant and machinery as on 1st April, 2004.

Telecom and Power undertakings should fulfil the following conditions:

a. It is not formed by splitting up or reconstruction of a business already in existence. However, this condition shall not apply in the case of an undertaking which is formed as a result of reconstruction, re-establishment or revival of the business of any undertaking which has been discontinued in any previous year due to extensive damage or destruction of any building, machinery, plant or furniture owned by the assessee and used for the purposes of such business. Further, the reason for damage or destruction is due to any natural calamity or other unforeseen circumstances such as the following:

(i) flood, typhoon, hurricane, cyclone, earthquake or other natural calamity, or

(ii) riot or civil disturbance, or

(iii) accidental fire or explosion, or

(iv) enemy action or action taken in combat, and such business is re-established or revived within 3 years from the end of such previous year.

b. The undertaking should not be formed by the transfer of machinery or plant previously used for any purpose.

However, these conditions do not apply in case of transfer, either in whole or in part, of machinery or plant previously used by a State Electricity Board. This is irrespective of whether or not such transfer is in pursuance of the splitting up or reconstruction of such State Electricity Board or reorganisation of the State Electricity Board under Part XIII of the Electricity Act, 2003.

Also, this condition shall not apply to second-hand machinery or plant imported by the assessee if the following conditions are fulfilled:

(i) Such machinery or plant was not used in India prior to the date of installation by the assessee.

(ii) No deduction on account of depreciation was allowed to any person prior to the date of installation by the assessee.

Further, where the total value of any plant or machinery previously used and now transferred to the new business does not exceed 20% of the total value of the machinery or plant used in the new business, such plant or machinery will be considered as new for this purpose.

(5) ***Undertakings owned by an Indian company and set up for reconstruction or revival of a power generating plant:*** Clause (v) provides that the benefit under this section is available to an undertaking owned by an Indian company and set up for reconstruction or revival of a power generating plant.

Such Indian company should be formed before 30.11.2005 with majority equity participation by public sector companies for the purposes of enforcing the security interest of the lenders to the company owning the power generating plant.

Such Indian company should have been notified before 31.12.2005 by the Central Government for the purposes of this clause. Such undertaking should begin to generate or transmit or distribute power before 31.3.2011.

Rate of Deduction

1. The amount of deduction available will be 100% of the profits and gains derived from such business for ten consecutive assessment years commencing at any time during the periods specified in point 3 mentioned below.
2. However, in case of telecom undertakings covered under (2) above, the deduction will be 100% for the first 5 assessment years and thereafter 30% for the further 5 assessment years.

Period of Tax Holiday or Concession

1. The assessee has the option to claim deduction for any 10 consecutive assessment years out of 15 years beginning from the year in which the undertaking or the enterprise develops or begins to operate the eligible business.
2. The assessee may also claim deduction for 10 out of 15 years beginning from the year in which an undertaking undertakes substantial renovation and modernization of the existing transmission or distribution lines.
3. In case of an infrastructure facility being a public facility like:

   (i) a road, including a toll road, bridge or rail system; or

   (ii) a highway project including housing or other activities which are an integral part of the highway project; or a water supply project, water treatment system, irrigation project, sanitation and sewerage system or solid waste management system, the assessee can claim deduction for any 10 consecutive assessment years out of 20 years beginning from the year of operation.

Other Provisions

1. For the purpose of computing deduction under this section, the profits and gains of the eligible business shall be computed as if such eligible business were the only source of income of the assessee during the relevant previous years (Sub-section (5)).

2. Where housing or other activities are an integral part of a highway project and the profits and gains have been calculated in accordance with the section, the profits shall not be liable to tax if the following conditions have been fulfilled:

   a. The profit has been transferred to a special reserve account; and

   b. The same is actually utilised for the highway project excluding housing and other activities before the expiry of 3 years following the year of transfer to the reserve account;

   c. The amount remaining unutilised shall be chargeable to tax as income of the year in which the transfer to the reserve account took place (Sub-section (6)).

3. The deduction shall be allowed to the industrial undertaking only if the accounts of the industrial undertaking for the relevant previous year have been audited by a chartered accountant and the assessee furnishes the audit report in the prescribed form, duly signed and verified by such accountant along with his return of income (Sub-section (7)).

4. Where any goods or services held for the purposes of the eligible business are transferred to any other business carried on by the assessee, or vice versa, and if the consideration for such transfer does not correspond with the market value of the goods or services then the profits and gains of the eligible business shall be computed as if the transfer was made at market value. However, if, in the opinion of the Assessing Officer, such computation presents exceptional difficulties, the Assessing Officer may compute the profits on such reasonable basis as he may deem fit (Sub-section (8)).

Notes For the purpose of section 80-IA(8), the market value, in relation to any goods or services transferred between the eligible business and any other business carried on by the assessee, shall mean:

1. The price that such goods or services would ordinarily fetch in the open market; or
2. The arm's length price as defined under section 92F, where the transfer of such goods or services is a specified domestic transaction referred to in section 92BA.

5. The deductions claimed and allowed under this section shall not exceed the profits and gains of the eligible business. Further, where deduction is claimed and allowed under this section for any assessment year no deduction in respect of such profits will be allowed under any other section under this chapter (Sub-section (9)).

6. The Assessing Officer is empowered to make an adjustment while computing the profit and gains of the eligible business on the basis of the reasonable profit that can be derived from the transaction, in case the transaction between the assessee carrying on the eligible business under section 80-IA and any other person is so arranged that the transaction produces excessive profits to the eligible business (Sub-section (10)).

Caution It has now been provided that if the aforesaid arrangement between the assessee carrying on the eligible business and any other person is a specified domestic transaction referred to in section 92BA, then, the amount of profit of such transaction shall be determined having regard to arm's length price as defined under section 92F and not as per the reasonable profit from such transaction.

7. The section empowers the Central Government to declare any class of industrial undertaking or enterprise as not being entitled to deduction under this section. The denial of exemption shall be with effect from such date as may be specified in the notification issued in the Official Gazette (Sub-section (11)).

8. In the case of any amalgamation or demerger, by virtue of which the Indian company carrying on the eligible business is transferred to another Indian company, deduction under this section will be available as follows:

   a. No deduction will be available to the amalgamating company or the demerged company, as the case may be, in the year of amalgamation or demerger.

   b. The provisions of this section will apply to the amalgamated or resulting company as they would have applied to the amalgamating or demerged company if the amalgamation or demerger had not taken place (Sub-section (12)).

   However, such transfer of benefit of deduction to the amalgamated/resulting company would not be available in respect of any enterprise or undertaking which is transferred in a scheme of amalgamation or demerger affected on or after 1.4.2007 (Sub-section (12A)).

9. The deduction under section 80-IA would not be available in respect of any SEZ notified on or after 1.4.2005 in accordance with the Industrial Park Scheme, 2002 and notified schemes for SEZs, referred to in section 80-IA(4)(c)(iii) (Sub-section (13)).

10. The tax holiday under section 80-IA would not be available in relation to a business referred to in sub-section (4) which is in the nature of a works contract awarded by any person (including the Central or State Government) and executed by the undertaking or enterprise referred to in section 80-IA(1).

Caselet

Corporate Income Tax: Small Benefits, but SEZs Dealt a MAT Blow

The corporate surcharge has been lowered from 7.5% to 5%. That reduces the effective corporate tax rate from 33.2% to 32.4%, which is a nice, even if small, relief for Indian companies. The new rate will be 30% plus a 5% surcharge, which works out to 31.5%, and after adding the education cess of 3%, it works out to 32.4%.

But the Minimum Alternate Tax (MAT) which is levied on firms has been increased to 18.5% of book profits from 18% earlier. This was to compensate for the lower surcharge, according to the FM. MAT is levied on those firms whose profits as per the Income Tax Act, is lower than that in their books prepared under the Companies Act.

So, companies will have to pay 18.5% of their book profits or tax as per the Income Tax Act, whichever is higher. But this tax is adjustable against future taxes payable. That is, when the company exits the tax holiday, or any other situation, which is lowering its tax incidence, it will be able to set off its MAT credit against the tax liability. This is in the nature of an advance tax, which lowers the cash flow of the company and in turn, hikes the cash flows of the government.

The Special Economic Zone Act has come under fire on several fronts. Earlier, profits earned by SEZ developers and units operating in these SEZs were exempt from tax.

Contd...

In addition, the dividend paid by these SEZ units was exempt from tax, compared to other companies who paid a dividend distribution tax of 15%. This will go. The exemption of tax on dividends ends from June 2011 itself. This again does not affect their profits but will reduce the profits available for distributing to shareholders.

SEZ profits will continue to be exempt from income tax, but they were also exempt from MAT. Now, they have to pay MAT of 18.5% on their profits earned in 2011-12. Their profits will fall to that extent. As said earlier, this is a cash flow and timing-related effect, and they will be able to set it off against future profits, as and when they become taxable.

But the SEZs may have to wait for a very long time for that. At present, units set up in SEZs get a 100% exemption on profits for the first five years, 50% for the next five years, and then 50% of the export profit reinvested in the business. And, developers of SEZs could get a tax holiday for 10 out of 15 years from the time it was notified. That is, their tax incidence will go up substantially only after 10 years.

In one shot, the government has ensured it loses no revenue (cash flow) due to companies using SEZs for their business nor from developers who were racing to set up residential and commercial complexes near the eligible areas surrounding the SEZ, and were eligible for tax exemptions.

Source: http://www.indiabusinessview.com/news/921/corporate-income-tax-small-benefits-sezs-dealt-mat-blow

Self Assessment

State which of the following is true or false in the context of the coverage of industrial undertaking:

1. A road, including toll road, a bridge or a rail system.
2. A highway project including housing or other activities being an integral part of the highway project.
3. Any undertaking providing telecommunication services, whether basic or cellular.
4. Any undertaking which develops, develops and operates, or maintains and operates, a special economic zone.
5. A port, airport, inland waterway or inland port or navigational channel in the sea.

6.2 Deduction in Respect of Profits and Gains by an Undertaking or Enterprise Engaged in Development of SEZ (Section 80-IAB)

Sub-section (1) of Section 80-IAB provides for a deduction of 100% of profits and gains derived by an undertaking or an enterprise from any business of developing a SEZ for 10 consecutive assessment years. The deduction is available to an assessee, being a Developer, whose gross total income includes any profits and gains derived by an undertaking or an enterprise from any business of developing a SEZ, notified on or after 1st April, 2005 under the SEZ Act, 2005.

Here Developer means -

(i) a person who, or

(ii) a State Government

which has been granted a letter of approval by the Central Government under section 3(10) of the SEZ Act, 2005.

Notes

A developer includes:

(i) an authority and

(ii) a Co-developer.

Here Co-developer means:

(i) a person who, or

(ii) a State Government

which has been granted a letter of approval by the Central Government under section 3(12) of the SEZ Act, 2005.

The deduction shall be allowed only if the accounts are audited by a Chartered Accountant and the audit report is furnished along with the return of income. The assessee has the option of claiming the said deduction for any ten consecutive assessment years out of fifteen years beginning from the year in which a SEZ has been notified by the Central Government.

In a case where an undertaking, being a Developer, who develops a SEZ on or after 1.4.2005 and transfers the operation and maintenance of such SEZ to another Developer, the deduction under sub-section (1) shall be allowed to such transferee Developer for the remaining period in the ten consecutive assessment years as if the operation and maintenance were not so transferred to the transferee Developer.

The profits and gains from the eligible business should be computed as if such eligible business were the only source of income of the assessee during the relevant assessment year.

Task Take any Indian firm of your choice who is engaged in development of SEZ and critically analyse on the deduction availed by it in respect of profits and gains incurred by it.

Where any goods or services held for the purposes of eligible business are transferred to any other business carried on by the assessee or, where any goods held for any other business are transferred to the eligible business and, in either case, if the consideration for such transfer as recorded in the accounts of the eligible business does not correspond to the market value thereof, then the profits eligible for deduction shall be computed by adopting market value for such goods or services. In case of exceptional difficulty in this regard, the profits shall be computed by the Assessing Officer on a reasonable basis.

Notes India was one of the first in Asia to recognize the effectiveness of the Export Processing Zone (EPZ) model in promoting exports, with Asia's first EPZ set up in Kandla in 1965. With a view to overcome the shortcomings experienced on account of the multiplicity of controls and clearances; absence of world-class infrastructure, and an unstable fiscal regime and with a view to attract larger foreign investments in India, the Special Economic Zones (SEZs) Policy was announced in April 2000.

Where due to the close connection between the assessee and the other person or for any other reason, it appears to the Assessing Officer that the profits of eligible business is increased to more than the ordinary profits, the Assessing Officer shall compute the amount of profits on a reasonable basis for allowing the deduction. The Assessing Officer is empowered to make an adjustment while computing the profit and gains of the eligible business on the basis of the reasonable profit that can be derived from the transaction, in case the transaction between the assessee carrying on the eligible business under section 80-IAB and any other person is so arranged that the transaction produces excessive profits to the eligible business.

Caution It has now been provided that if the aforesaid arrangement between the assessee carrying on the eligible business and any other person is a specified domestic transaction referred to in section 92BA, then, the amount of profit of such transaction shall be determined having regard to arm's length price as defined under section 92F and not as per the reasonable profit from such transaction.

The deduction under this section should not exceed the profits of such eligible business of the undertaking or the enterprise. Further, where any amount of profits of an undertaking or enterprise is allowed as deduction under this section, no deduction under any other provision of Chapter VI-A is allowable in respect of such profits. The Central Government may notify that the benefit conferred by this section shall not apply to any class of industrial undertaking or enterprise with effect from any specified date.

Where any undertaking of an Indian company which is entitled to the deduction under this section is transferred before the expiry of the period of deduction to another Indian company in a scheme of amalgamation or demerger, no deduction shall be admissible to the amalgamating or demerged company for the previous year in which the amalgamation or demerger takes place and the amalgamated or the resulting company shall be entitled to the deduction as if the amalgamation or demerger had not taken place.

Self Assessment

Fill in the blanks:

6. Sub-section (1) of Section 80-IAB provides for a deduction of 100% of profits and gains derived by an undertaking or an enterprise from any business of developing a SEZ for ………………consecutive assessment years.
7. Developer means a ……………..which has been granted a letter of approval by the Central Government under section 3(10) of the SEZ Act, 2005.
8. Co-developer means a person who, or a State Government which has been granted a letter of approval by the Central Government under ………………of the SEZ Act, 2005.
9. The deduction under section 80-IAB shall be allowed only if the accounts are audited by a Chartered Accountant and the audit report is furnished along with the …………………….
10. The deduction under section 80-IAB should not exceed the…………… of such eligible business of the undertaking or the enterprise.

6.3 Special Provisions in Respect of Certain Undertakings or Enterprises in Certain Special Category States (Section 80-IC)

Section 80-IC allows tax holiday to the new undertakings or existing undertakings on their substantial expansion in the states of Himachal Pradesh, Uttaranchal, Sikkim and North-Eastern States.

Notes

For this purpose, substantial expansion means increase in the investment in plant and machinery by at least 50% of the book value of the plant and machinery (before taking depreciation in any year), as on the first day of the previous year in which the substantial expansion is undertaken.

The tax holiday in the states of Himachal Pradesh and Uttaranchal will be 100% for the first five assessment years and 25% (30% in the case of a company) for the next five assessment years. However, tax holiday in the states of Sikkim and North-Eastern States will be 100% for ten assessment years commencing from the initial assessment year.

For the purpose of exemption, two classifications have been made and the Thirteenth Schedule and Fourteenth Schedule have been inserted in the Income-tax Act. The said Schedules specify the list of articles and the States for the purposes of availing deduction under this section.

The first classification is applicable to undertakings or enterprises which manufacture or produce any article or thing, not being any article or thing specified in the 13th Schedule (namely, tobacco, aerated beverages, pollution causing paper and paper products etc.) in any export processing zone or integrated infrastructure development centre or industrial growth centre or industrial estate or industrial park or software technology park or industrial areas or theme park in these States as notified by the Board. The second classification is applicable to those undertakings or enterprises which manufacture or produce article or thing specified in the 14th Schedule only in these States without any specification of the specified zone, area etc.

Did u know? The period during which the undertakings in different States should begin or should have begun to manufacture or produce are given hereunder:

Himachal Pradesh and Uttaranchal	From 7.1.03 and ending before 1.4.2012
Sikkim	From 23.12.02 and ending before 1.4.2007
North-Eastern States	From 24.12.97 and ending before 1.4.2007

No benefit to these undertakings will be available under any of the sections in Chapter VIA in relation to the profits and gains of such undertakings. While computing the total period of 10 years the period for which the benefit under section 80IB has already been availed, if any, shall also be included.

Task Take any company of your choice in India which has availed the benefit of Special provisions in respect of certain undertakings or enterprises in certain special category States as provided by Section 80-IC.

The other conditions such as that it should not be formed by splitting or reconstruction of a business already in existence, or by transfer to a new business of plant and machinery previously used for any purpose are the same as are applicable for claiming benefit under section 80IA.

Where any goods or services held for the purposes of the eligible business are transferred to any other business carried on by the assessee, or vice versa, and if the consideration for such transfer does not correspond with the market value of the goods or services then the profits and gains of the eligible business shall be computed as if the transfer was made at market value. However, if, in the opinion of the Assessing Officer, such computation presents exceptional difficulties, the Assessing Officer may compute the profits on such reasonable basis as he may deem fit.

The deductions claimed and allowed under this section shall not exceed the profits and gains of the eligible business.

Notes Assessing Officer" (AO) means the Income-Tax Officer or Assistant Commissioner of Income-Tax or Deputy Commissioner of Income-Tax or Joint Commissioner of Income-Tax or Additional Commissioner of Income-Tax who is authorized by the Board to exercise or perform all or any of the powers and functions conferred on, or assigned to an AO under the Income tax Act, 1961.

The Assessing Officer is empowered to make an adjustment while computing the profit and gains of the eligible business on the basis of the reasonable profit that can be derived from the transaction, in case the transaction between the assessee carrying on the eligible business under section 80-IC and any other person is so arranged that the transaction produces excessive profits to the eligible business.

Caution With the increasing usage of Internet for Income Tax related work including tasks such as applying for PAN and TAN or for filing Income Tax returns, the common problem being faced by many taxpayers and assessees is how to find out their particular Circle/Ward/Range in which they need to file return with or are assessed with.

Self Assessment

Fill in the blanks:

11. ……………..allows tax holiday to the new undertakings or existing undertakings on their substantial expansion in the states of Himachal Pradesh, Uttaranchal, Sikkim and North-Eastern States.
12. The tax holiday in the states of Himachal Pradesh and Uttaranchal will be 100% for the first five assessment years and ………………. for the next five assessment years.
13. Tax holiday in the states of Sikkim and North-Eastern States will be …………………for ten assessment years commencing from the initial assessment year.

6.4 Tax Holiday in Respect of Profits and Gains from Eligible Business of Certain Undertakings in North-Eastern States (Section 80-IE)

This section provides for an incentive to an undertaking which has during the period between 1st April, 2007 and 1st April, 2017, begun or begins, in any of the North-Eastern States (i.e., the States of Arunachal Pradesh, Assam, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim and Tripura) -

1. to manufacture or produce any eligible article or thing;
2. to undertake substantial expansion to manufacture or produce any eligible article or thing;
3. to carry on any eligible business.

   Eligible article or thing means the article or thing other than the following:

   a. goods falling under Chapter 24 of the First Schedule to the Central Excise Tariff Act, 1985 which pertains to tobacco and manufactured tobacco substitutes;
   b. pan masala as covered under Chapter 21 of the First Schedule to the Central Excise Tariff Act, 1985;

Notes

c. plastic carry bags of less than 20 microns; and

d. goods falling under Chapter 27 of the First Schedule to the Central Excise Tariff Act, 1985 produced by petroleum oil or gas refineries.

Substantial expansion means increase in the investment in the plant and machinery by at least 25% of the book value of plant and machinery (before taking depreciation in any year), as on the first day of the previous year in which the substantial expansion is undertaken.

Eligible business means the business of -

a. hotel (not below two star category);

b. adventure and leisure sports including ropeways;

c. providing medical and health services in the nature of nursing home with a minimum capacity of 25 beds;

d. running an old-age home;

e. operating vocational training institute for hotel management, catering and food craft, entrepreneurship development, nursing and Para-medical, civil aviation related training, fashion designing and industrial training;

f. running information technology related training centre;

g. manufacturing of information technology hardware; and

h. Bio-technology.

Where the gross total income of an assessee includes any profits and gains derived by such an undertaking, a deduction of 100% of the profits and gains derived from such business for 10 consecutive assessment years commencing with the initial assessment year shall be allowed in computing the total income of the assessee. Initial assessment year means the assessment year relevant to the previous year in which the undertaking begins to manufacture or produce articles or things, or completes substantial expansion.

However, the following conditions have to be fulfilled by the undertaking for claiming benefit of deduction under this section:

1. It should not be formed by splitting up, or the reconstruction, of a business already in existence (except in circumstances provided in section 33B)

2. It should not be formed by the transfer to a new business of machinery or plant previously used for any purpose exceeding 20% of the total value of machinery and plant used in the business.

For this purpose, any machinery or plant which was used outside India by any person other than the assessee shall not be regarded as machinery or plant previously used for any purpose if the following conditions are fulfilled:

a. such machinery or plant was not at any time used in India;

b. such machinery or plant is imported into India from any country outside India; and

c. no deduction on account of depreciation has been allowed in respect of such machinery or plant to any person earlier.

Where deduction has been allowed under this section in computing the total income of the assessee, no deduction shall be allowed under any other section contained in Chapter VIA or section 10AA in relation to the profits and gains of the undertaking. Further, no deduction shall be allowed to any undertaking under this section, where the total period of deduction inclusive of the period of deduction under this section, or under section 80-IC or under the second proviso to sub-section (4) of section 80-IB, as the case may be, exceeds 10 assessment years.

The profits and gains from the eligible business should be computed as if such eligible business were the only source of income of the assessee during the relevant assessment year.

The deduction under this section should not exceed the profits of such eligible business of the undertaking. The deduction shall be allowed only if the accounts are audited by a Chartered Accountant, who is also required to certify that the deduction has been correctly claimed. Further, the audit report should be furnished along with the return of income.

Where any goods or services held for the purposes of eligible business are transferred to any other business carried on by the assessee or, where any goods held for any other business are transferred to the eligible business and, in either case, if the consideration for such transfer as recorded in the accounts of the eligible business does not correspond to the market value thereof, then the profits eligible for deduction shall be computed by adopting market value for such goods or services. In case of exceptional difficulty in this regard, the profits shall be computed by the Assessing Officer on a reasonable basis.

Notes Assessment Information System" (AST): AST module is the core process of ITD applications conceptualized as an on-line, menu driven software capable of carrying out all assessment and related functions.

The Assessing Officer is empowered to make an adjustment while computing the profit and gains of the eligible business on the basis of the reasonable profit that can be derived from the transaction, in case the transaction between the assessee carrying on the eligible business under section 80-IE and any other person is so arranged that the transaction produces excessive profits to the eligible business.

Caution It has now been provided that if the aforesaid arrangement between the assessee carrying on the eligible business and any other person is a specified domestic transaction referred to in section 92BA, then, the amount of profit of such transaction shall be determined having regard to arm’s length price as defined under section 92F and not as per the reasonable profit from such transaction.

Similarly, where due to the close connection between the assessee and the other person or for any other reason, it appears to the Assessing Officer that the profits of eligible business is increased to more than the ordinary profits, the Assessing Officer shall compute the amount of profits on a reasonable basis for allowing the deduction. The Central Government may notify that the benefit conferred by this section shall not apply to any class of undertaking with effect from any specified date. Where any undertaking of an Indian company which is entitled to the deduction under this section is transferred before the expiry of the period of deduction to another Indian company in a scheme of amalgamation or demerger, no deduction shall be admissible to the amalgamating or demerged company for the previous year in which the amalgamation or demerger takes place and the amalgamated or the resulting company shall be entitled to the deduction as if the amalgamation or demerger had not taken place.

Self Assessment

State whether the following statements are true or false:

14. Substantial expansion means increase in the investment in the plant and machinery by at least 25% of the book value of plant and machinery, as on the first day of the previous year in which the substantial expansion is undertaken.

15. Where the gross total income of an assessee includes any profits and gains derived by such an undertaking, a deduction of 100% of the profits and gains derived from such business for 5 consecutive assessment years
16. Where deduction has been allowed under this section in computing the total income of the assessee, only 25% deduction shall be allowed under any other section contained in Chapter VIA or section 10AA in relation to the profits and gains of the undertaking.
17. The profits and gains from the eligible business should be computed as if such eligible business were the only source of income of the assessee during the relevant assessment year.

6.5 Application of the above Special Conditions

The application of the deduction available under special circumstance can be availed by an undertaking or an enterprise only on fulfilment of certain important conditions which though mentioned above is explained in detail below:

Application of Section Relating to Tax Deductions by SEZ

As per section 10A(7B) of the IT Act, deduction under section 10A can be claimed by the unit in SEZ, which has begun to manufacture or produce articles or things or computer software between 1 April 2000 to 31 March 2005. No deduction under section 10A will be allowed to the SEZ unit, which has begun (to manufacture or produce articles or things) on or after 1 April 2005 i.e. year ended 31 March 2006 (AY 2006-07).

As per the proviso to section 10AA(3) of the IT Act, if due to the application of 10A(7B), deduction under section 10A is not available to the eligible unit in SEZ, then the said unit shall be able to claim deduction under section 10AA for the unexpired period of 10 consecutive AYs.

From the above, it can be observed that proviso to section 10AA (3) entitles deduction for unexpired period of 10 consecutive AYs to an unit, which became ineligible to claim deduction under section 10A due to application of sub-section 7B of section 10A.

Section 10A (7B) makes those unit ineligible to claim deduction under section 10A, which have begun after 1 April 2005. Section 10AA (1) provides for deduction only to those units which began after 1 April 2005.

In view of the above, it is not clear that proviso to section 10AA(3) refers to which units to be eligible to claim deduction for the unexpired period. This is because by virtue of section 10A(7B), those units which have begun after 1 April 2005 are not eligible for deduction under section 10A as such units are automatically eligible to claim deduction under section 10AA as per proviso of section 10AA(1). In case of such units, there cannot be question of unexpired period because they began only after 1 April 2005.

Section 80-IAB applies to any industrial undertaking which fulfils all the following conditions, namely:

1. It is not formed by splitting up, or the reconstruction, of a business already in existence: Provided that this condition shall not apply in respect of an industrial undertaking which is formed as a result of the re-establishment, reconstruction or revival by the assessee of the business of any such industrial undertaking as is referred to in section 33B, in the circumstances and within the period specified in that section.
2. It is not formed by the transfer to a new business of machinery or plant previously used for any purpose.
3. It manufactures or produces any article or thing, not being any article or thing specified in the list in the Eleventh Schedule, or operates one or more cold storage plant or plants, in any part of India: Provided that the condition in this clause shall, in relation to a small

scale industrial undertaking or an industrial undertaking referred to in sub-section (4) shall apply as if the words "not being any article or thing specified in the list in the Eleventh Schedule" had been omitted.

Explanation 1.—For the purposes of clause (ii), any machinery or plant which was used outside India by any person other than the assessee shall not be regarded as machinery or plant previously used for any purpose, if the following conditions are fulfilled, namely:

a. Such machinery or plant was not, at any time previous to the date of the installation by the assessee, used in India;

b. Such machinery or plant is imported into India from any country outside India; and

c. No deduction on account of depreciation in respect of such machinery or plant has been allowed or is allowable under the provisions of this Act in computing the total income of any person for any period prior to the date of the installation of the machinery or plant by the assessee.

Explanation 2.—Where in the case of an industrial undertaking, any machinery or plant or any part thereof previously used for any purpose is transferred to a new business and the total value of the machinery or plant or part so transferred does not exceed twenty per cent of the total value of the machinery or plant used in the business, then, for the purposes of clause (ii) of this sub-section, the condition specified therein shall be deemed to have been complied with;

4. In a case where the industrial undertaking manufactures or produces articles or things, the undertaking employs ten or more workers in a manufacturing process carried on with the aid of power, or employs twenty or more workers in a manufacturing process carried on without the aid of power.

Section 80-IC applies to any industrial undertaking which fulfils all the following conditions, namely:

This section applies to any undertaking or enterprise:

a. Which has begun or begins to manufacture or produce any article or thing, not being any article or thing specified in the Thirteenth Schedule, or which manufactures or produces any article or thing, not being any article or thing specified in the Thirteenth Schedule and undertakes substantial expansion during the period beginning:

   (i) On the 23rd day of December, 2002 and ending before the 1st day of April, 2012, in any Export Processing Zone or Integrated Infrastructure Development Centre or Industrial Growth Centre or Industrial Estate or Industrial Park or Software Technology Park or Industrial Area or Theme Park, as notified by the Board in accordance with the scheme framed and notified by the Central Government in this regard, in the State of Sikkim; or

   (ii) On the 7th day of January, 2003 and ending before the 1st day of April, 2012, in any Export Processing Zone or Integrated Infrastructure Development Centre or Industrial Growth Centre or Industrial Estate or Industrial Park or Software Technology Park or Industrial Area or Theme Park, as notified by the Board in accordance with the scheme framed and notified by the Central Government in this regard, in the State of Himachal Pradesh or the State of Uttaranchal; or

   (iii) On the 24th day of December, 1997 and ending before the 1st day of April, 2007, in any Export Processing Zone or Integrated Infrastructure Development Centre or Industrial Growth Centre or Industrial Estate or Industrial Park or Software Technology Park or Industrial Area or Theme Park, as notified by the Board in

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accordance with the scheme framed and notified by the Central Government in this regard, in any of the North-Eastern States;

b. Which has begun or begins to manufacture or produce any article or thing, specified in the Fourteenth Schedule or commences any operation specified in that Schedule, or which manufactures or produces any article or thing, specified in the Fourteenth Schedule or commences any operation specified in that Schedule and undertakes substantial expansion during the period beginning:

   (i) On the 23rd day of December, 2002 and ending before the 1st day of April, 2012, in the State of Sikkim; or

   (ii) On the 7th day of January, 2003 and ending before the 1st day of April, 2012, in the State of Himachal Pradesh or the State of Uttaranchal; or

   (iii) On the 24th day of December, 1997 and ending before the 1st day of April, 2007, in any of the North-Eastern States.

Section 80-IE applies to any industrial undertaking which fulfils all the following conditions, namely:

This section applies to any undertaking which has, during the period beginning on the 1st day of April, 2007 and ending before the 1st day of April, 2017, begun or begins, in any of the North-Eastern States:

(i) to manufacture or produce any eligible article or thing;

(ii) to undertake substantial expansion to manufacture or produce any eligible article or thing;

(iii) to carry on any eligible business.

This section also applies to any undertaking which fulfils all the following conditions, namely:

(i) it is not formed by splitting up, or the reconstruction, of a business already in existence :Provided that this condition shall not apply in respect of an undertaking which is formed as a result of the re-establishment, reconstruction or revival by the assessee of the business of any such undertaking as referred to in section 33B, in the circumstances and within the period specified in the said section;

(ii) it is not formed by the transfer to a new business of machinery or plant previously used for any purpose.

Explanation—the provisions of Explanations 1 and 2 to sub-section (3) of section 80-IA shall apply for the purposes of clause (ii) of this sub-section as they apply for the purposes of clause (ii) of that sub-section.

Notwithstanding anything contained in any other provision of this Act, in computing the total income of the assessee, no deduction shall be allowed under any other section contained in Chapter VIA or in section 10A or section 10AA or section 10B or section 10BA, in relation to the profits and gains of the undertaking.

Notwithstanding anything contained in this Act, no deduction shall be allowed to any undertaking under this section, where the total period of deduction inclusive of the period of deduction under this section, or under section 80-IC or under the second proviso to sub-section (4) of section 80-IB or under section 10C, as the case may be, exceeds ten assessment years.

The provisions contained in sub-section (5) and sub-sections (7) to (12) of section 80-IA shall, so far as may be, apply to the eligible undertaking under this section.

Notes

For the purposes of this section:

(i) "initial assessment year" means the assessment year relevant to the previous year in which the undertaking begins to manufacture or produce articles or things, or completes substantial expansion;

(ii) "North-Eastern States" means the States of Arunachal Pradesh, Assam, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim and Tripura;

(iii) "substantial expansion" means increase in the investment in the plant and machinery by at least twenty-five per cent of the book value of plant and machinery (before taking depreciation in any year), as on the first day of the previous year in which the substantial expansion is undertaken;

(iv) "eligible article or thing" means the article or thing other than the following :—

- goods falling under Chapter 24 of the First Schedule to the Central Excise Tariff Act, 1985 (5 of 1986) which pertains to tobacco and manufactured tobacco substitutes;
- pan masala as covered under Chapter 21 of the First Schedule to the Central Excise Tariff Act, 1985 (5 of 1986);
- plastic carry bags of less than 20 microns as specified by the Ministry of Environment and Forests vide Notification No. S.O. 705(E), dated the 2nd September, 1999 and S.O. 698(E), dated the 17th June, 2003; or
- goods falling under Chapter 27 of the First Schedule to the Central Excise Tariff Act, 1985 (5 of 1986), produced by petroleum oil or gas refineries;

(v) "eligible business" means the business of hotel (not below two star category); adventure and leisure sports including ropeways; providing medical and health services in the nature of nursing home with a minimum capacity of 25 beds; running an old-age home, pertaining vocational training institute for hotel management, catering and food craft, entrepreneurship development, nursing and para-medical, civil aviation related training, fashion designing and industrial training; running information technology related training centre; manufacturing of information technology hardware; and bio-technology.

Self Assessment

Fill in the blanks:

18. As per section 10A (7B) of the IT Act, deduction under section 10A can be claimed by the unit in …………………
19. Section 10A (7B) makes those unit ineligible to claim deduction under section 10A, which have begun after ………………..
20. Section 80-IC applies to any undertaking or enterprise which has begun or begins to manufacture or produce any article or thing, not being any article or thing specified in the ………………….
21. …………………..means the States of Arunachal Pradesh, Assam, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim and Tripura1.

Notes

Case Study

Coimbatore Hitech Infrastructure (P.) Ltd. vs Additional Commissioner of Income-tax, Range-I, Coimbatore

The assessee is a company engaged in the business of developing Special Economic Zone (SEZ) at Keeranatham Village, Coimbatore. The assessee company has set up a sector specific SEZ for Information Technology and Information Technology Enabled Services. A SEZ is set up, approved and governed under the provisions of The Special Economic Zones Act (SEZ Act), 2005 and The Special Economic Zones Rules (SEZ Rules), 2006 made there under. The administration of the scheme is vested with the SEZ authority functioning under the Rules promulgated in 2009.

The assessee company has satisfied the conditions to be complied with for obtaining approval from the competent authority notified under the SEZ Act. The Department of Commerce in the Ministry of Commerce and Industry, Government of India has granted the approval to the assessee company for setting up the sector specific SEZ through their proceedings dated 20.8.2006. The SEZ set up by the assessee company has been notified by the concerned authority in Official Gazette as required under the SEZ Act, 2005. In short, the assessee company is fully approved to develop SEZ under the SEZ Act, 2005.

In view of the approval granted by the competent authority, the assessee company carried out its activities to set up the SEZ. As per the SEZ Act, 2005, the assessee is in the status of a Developer, who shall develop, operate and maintain the SEZ in terms of the SEZ Act, 2005 and the Rules made there under. A Developer for the purpose of the SEZ Act, 2005 also includes a Co-Developer. After having developed SEZ as per the conditions laid down in the approval granted by the competent authority, the assessee has let out the developed lands to three parties in the previous year relevant to the assessment year under appeal. The three parties are M/s. Robert Bosch India Ltd., M/s. Cognizant Technology Solutions India (P) Ltd. and M/s. KGISL IT Parks (P) Ltd. The assessee has leased out 21.88 acres, 23.68 acres and 11.74 acres respectively.

As the assessee company is an approved and notified SEZ, it claimed deduction in respect of its income, being profits and gains arising from development of SEZ as provided under sec.80-IAB. The deduction provided under sec.80-IAB is 100% of the profits and gains by an undertaking or entrepreneur engaged in the development of SEZ. Accordingly, the assessee filed a 'NIL' return of income.

The Assessing Officer, in the course of assessment proceedings examined the case in detail. He found that the assessee has developed a SEZ as provided under the SEZ Act, 2005 in the specific sector of Information Technology and Information Technology Enabled Services. He examined the conditions laid down in the approval given by the competent authority. One of the conditions is that the assessee shall develop a minimum area of one lakhs square meters. The Assessing Officer found that the assessee has not completed that minimum built up area by the end of the previous year relevant to the assessment year under appeal. The Assessing Officer accordingly, pointed out a case of breach of one condition stipulated in the approval granted to the assessee as a SEZ. The assessing authority has observed in page 10 of his order that "It is apparent from the details filed that this condition has not been fulfilled by the assessee in order to qualify for the deduction".

Contd...

The Assessing Officer further observed that the assessee company has derived income only in the form of lease premium on leasing out the lands to three different companies and the assessee company has not derived any profits and gains as a developer of the SEZ. According to the Assessing Officer, the income declared by the assessee company has not been derived from the business of developing SEZ. The reason to come to the above conclusion is that the assessee company has given the land on a perennial lease of 99 years with further scope of renewal, which in effect is nothing but a sale. Relying on the decision of the Hon'ble Supreme Court in the case of *R. Palshikar (HUF)* v. *CIT* (172 ITR 311), the Assessing Officer held that the long term lease of 99 years granted by the assessee company is nothing but sale of land. He, therefore, held that the income of the assessee company was in the nature of capital gains arising on sale of land. He accordingly, declined assessee's claim of deduction under sec.80-IAB.

Once the Assessing Officer denied the exemption to the assessee company under sec.80-IAB, he also made certain other additions to the taxable income of the assessee company. The assessee company has created a provision for project development cost on the basis of estimates for different works to the extent of ₹ 24,60,28,194/-. The assessee has treated an amount of ₹ 7,88,47,215/- as proportionate project development cost for the unleased area, from the above total provision. It was accordingly, taken as stock inventory. The balance provision of ₹ 16,71,80,979/- has been claimed by the assessee as pertaining to leased out lands. According to the Assessing Officer, only an amount of ₹ 3,89,84,177/- was actually spent on the project in the previous year and even that amount was not taken as part of the closing stock. On the other hand, it was written off as expenses. The Assessing Officer therefore, held that the provision should be treated as relating to the development expenditure of land and, therefore, to be disallowed. Accordingly, the amount of ₹ 16,71,80,979/- was added to the income. The assessee has made a donation of ₹ 2 crore in the previous year and debited the profit and loss account. This amount was also disallowed by the Assessing Officer and added back to the income. Thus, finally, the Assessing Officer has determined a total income of ₹ 89,89,01,282/- in the hands of the assessee company.

The assessment went through different courts and the final verdict reflected that the assessee is an approved Developer of SEZ. The only activity carried on by the assessee is developing a sector specific SEZ. It has leased out the developed plots to the entrepreneurs who had obtained the letter of approval from the competent authority. Sec.80-IAB provides that setting up of a SEZ is the business of developing SEZ. Therefore, the assessee is not expected to perform any other activity than developing of a SEZ to qualify for deduction.

In the facts and circumstances of the case, we find that the lower authorities are not justified in refusing deduction under sec.80-IAB. The claim of deduction made by the assessee under sec.80-IAB is in accordance with law. The assessing authority is directed to give the deduction. Other issues raised in this appeal relating to different additions are only academic for the reason that those items, even if added to the total income of the assessee, are still part of 100% deduction available under sec.80-IAB; so also is the ground raised by the assessee on taxing of dividend income. This principle has been upheld by the Hon'ble Bombay High Court in *CIT* v. *Punit Commercial Ltd.* (245 ITR 550).The assessing authority is therefore, directed to re-do the assessment after giving the assessee deduction under sec.80-IAB. In result, this appeal filed by the assessee is allowed.

Questions

1. Study and analyse the case.
2. Write down the case facts.
3. What do you infer from it?

Source: http://taxguru.in/income-tax-case-laws/deduction-80iab-sez-developer-allowable-income-lease-rentals-developed-area.html

Notes

6.6 Summary

- A Special Economic Zone (SEZ) is a specified, delineated and duty-free geographical region that has different economic laws from those of the country in which it is situated. In some countries, such a region is even treated as a deemed foreign territory.
- The Special Economic Zones and Tax Incentives offered as per the SEZ policy of India are indeed alluring. The Special Economic Zones and Tax Incentives offered covers areas like state and local taxes, levies, stamp duty and other duties. As per the Income-tax Act, 1961 there are a number of key tax benefits to be provided to SEZs and SEZ Units.
- As per section 10A(7B) of the IT Act, deduction under section 10A can be claimed by the unit in SEZ, which has begun to manufacture or produce articles or things or computer software between 1 April 2000 to 31 March 2005. No deduction under section 10A will be allowed to the SEZ unit, which has begun (to manufacture or produce articles or things) on or after 1 April 2005 i.e. year ended 31 March 2006 (AY 2006-07).
- As per the proviso to section 10AA(3) of the IT Act, if due to the application of 10A(7B), deduction under section 10A is not available to the eligible unit in SEZ, then the said unit shall be able to claim deduction under section 10AA for the unexpired period of 10 consecutive AYs.
- Section 80-IA(1) provides a ten year tax holiday to an assessee, whose gross total income includes any profits and gains derived by an undertaking or enterprise from an eligible business i.e., business referred to in sub-section (4) including industrial undertaking, SEZ, industrial parks, power generation, telecomm and firms engaged in reconstruction of power unit.
- Infrastructure facility means a road, including toll road, a bridge or a rail system, a highway project including housing or other activities being an integral part of the highway project; a water supply project, water treatment system, irrigation project, sanitation and sewerage system or solid waste management system; and a port, airport, inland waterway or inland port or navigational channel in the sea.
- Any undertaking providing telecommunication services, whether basic or cellular, including radio paging, domestic satellite service or network of trunking (NOT), broadband network and internet services on or after 1 April, 1995 but on or before 31 March, 2005 can avail tax deductions.
- Sub-section (1) of Section 80-IAB provides for a deduction of 100% of profits and gains derived by an undertaking or an enterprise from any business of developing a SEZ for 10 consecutive assessment years. The deduction is available to an assessee, being a Developer, whose gross total income includes any profits and gains derived by an undertaking or an enterprise from any business of developing a SEZ, notified on or after 1 st April, 2005 under the SEZ Act, 2005.
- Section 80-IC allows tax holiday to the new undertakings or existing undertakings on their substantial expansion in the states of Himachal Pradesh, Uttaranchal, Sikkim and North-Eastern States. For this purpose, substantial expansion means increase in the investment in plant and machinery by at least 50% of the book value of the plant and machinery (before taking depreciation in any year), as on the first day of the previous year in which the substantial expansion is undertaken.
- The tax holiday in the states of Himachal Pradesh and Uttaranchal will be 100% for the first five assessment years and 25% (30% in the case of a company) for the next five assessment years. However, tax holiday in the states of Sikkim and North-Eastern States will be 100% for ten assessment years commencing from the initial assessment year.

- Section 80-IE_provides for an incentive to an undertaking which has during the period between 1st April, 2007 and 1st April, 2017, begun or begins, in any of the North-Eastern States (i.e., the States of Arunachal Pradesh, Assam, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim and Tripura) - _to manufacture or produce any eligible article or thing; to undertake substantial expansion to manufacture or produce any eligible article or thing; and_to carry on any eligible business.
- Eligible article or thing means the article or thing other than the goods falling under Chapter 24 of the First Schedule to the Central Excise Tariff Act, 1985 which pertains to tobacco and manufactured tobacco substitutes; pan masala as covered under Chapter 21 of the First Schedule to the Central Excise Tariff Act, 1985; plastic carry bags of less than 20 microns; and goods falling under Chapter 27 of the First Schedule to the Central Excise Tariff Act, 1985 produced by petroleum oil or gas refineries.
- Where the gross total income of an assessee includes any profits and gains derived by such an undertaking, a deduction of 100% of the profits and gains derived from such business for 10 consecutive assessment years commencing with the initial assessment year shall be allowed in computing the total income of the assessee. Initial assessment year means the assessment year relevant to the previous year in which the undertaking begins to manufacture or produce articles or things, or completes substantial expansion.

6.7 Keywords

Arm's Length Price: The price at which two unrelated and non-desperate parties would agree to a transaction.

Assessing Officer: He or she is an officer of the Income tax department who has been given jurisdiction over a particular geographical territory or class of persons.

Co-developer: It implies a person who, or a State Government which has been granted a letter of approval by the Central Government under section 3(12) of the SEZ Act, 2005.

Deduction: Any item or expenditure subtracted from gross income to reduce the amount of income subject to tax.

Developer: It is a person who, or a State Government which has been granted a letter of approval by the Central Government under section 3(10) of the SEZ Act, 2005.

Domestic Satellite: It is a satellite owned and operated by an Indian company for providing telecommunication services.

Market Value: It is the price at which an asset would trade in a competitive auction setting.

SEZs: These are free trade zones, having completely different set of administrative and taxation laws outside the purview of customs authorities.

Substantial Expansion: It means increase in the investment in the plant and machinery by at least 25% of the book value of plant and machinery as on the first day of the previous year in which the substantial expansion is undertaken.

Telecom Undertakings: Any undertaking providing telecommunication services, whether basic or cellular, including radio paging, domestic satellite service or network of trunking (NOT), broadband network and internet services on or after 1 April, 1995 but on or before 31 March, 2005.

6.8 Review Questions

1. What do you understand by an infrastructure facility?
2. In order to be referred to as infrastructure facility what all conditions are to be fulfilled by an organisation?
3. Define SEZ.
4. Explain the deductions available to power undertakings.
5. Write a note on deductions available to undertakings for reconstruction or revival of power generating plants.
6. Differentiate between a developer and a co-developer in context with calming deductions relating SEZ.
7. Explain the Deduction available in respect of profits and gains by an undertaking or enterprise engaged in development of SEZ.
8. Comment on the statement, "Section 80-IC allows tax holiday to the new undertakings or existing undertakings on their substantial expansion in the states of Himachal Pradesh, Uttaranchal, Sikkim and North-Eastern States".
9. Define the following in context with Section 80-IE of Income Tax Act:
   (a) Eligible article or thing
   (b) Substantial expansion
   (c) Eligible business
10. Mention the conditions that are needed to be fulfilled by the undertaking for claiming benefit of deduction under Section 80-IE of Income Tax Act.
11. Mention the application criteria for taking the benefits of deductions available under special conditions of IT Act.

Answers: Self Assessment

1. True
2. True
3. False
4. False
5. True
6. Ten
7. Person who, or State Government
8. Section 3(12)
9. Return of income.
10. Profits
11. Section 80-IC
12. 25%
13. 100%
14. True
15. False
16. False
17. True
18. SEZ
19. 1 April 2005
20. Thirteenth Schedule
21. North-Eastern States

6.9 Further Readings

Books

Aggarwal, K. *Direct Tax Planning and Management.* Atlantic Publications.

Ahuja, G. K. & Gupta, Ravi. *Systematic Approach to Income Tax.* Bharat Law House.

Lakhotia, R. N. *Income Tax Planning Handbook.* Vision Books.

Singhania, V. K. & Singhania, Kapil. *Direct Taxes Law & Practice.* Taxmann Publications.

Srinivas E. A. *Handbook of Corporate Tax Planning.* Tata McGraw Hill.

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http://www.nishithdesai.com/Research-Papers/SEZ-Final.pdf

Unit 7: Income under the Head Salaries

Notes

CONTENTS

Objectives

After studying this unit, you will be able to:

- Define the Salary
- Discuss the Basis of charge of salary
- Describe the Allowances and Perquisites

- Explain the Types of perquisites
- Compute the Valuation of Perquisites
- Trace the cases of Profits in lieu of or in addition to salary
- List down the Deductions allowed from salaries (section 16)

Introduction

Income is taxable under the IT Act under five basic heads of income. It is important to understand the basics of these heads of income, to have more clarity as to how your taxable income and tax payable is computed. The income earned by any person is computed under the following categories:

- Income from Salary
- Income from House Property
- Income from Business of Profession
- Income from Capital Gains
- Income from other sources

In this unit we will study the very first head of income i.e., "Income from Salaries". Income under the head salaries covers all possible remuneration due or paid to a person in respect of services rendered by him in an express or implied contract of employment. However, arrears of salary are taxable on payment basis and not on due basis. Payment received by an individual other than an employer cannot be termed as salary and consequently cannot be taxed under this head. Salary is taxed on due basis or receipt basis whichever is earlier. If the employer pays the salary tax-free the employee has to include in his taxable income not only the salary but also the amount of tax paid by the employer.

7.1 Definition of Salary

Salary is the remuneration received by or accruing to an individual, periodically, for service rendered as a result of an express or implied contract. The actual receipt of salary in the previous year is not material as far as its taxability is concerned. The existence of employer-employee relationship is the sine-qua-non for taxing a particular receipt under the head "salaries."

Example: The salary received by a partner from his partnership firm carrying on a business is not chargeable as "Salaries" but as "Profits & Gains from Business or Profession". Similarly, salary received by a person as MP or MLA is taxable as "Income from other sources", but if a person received salary as Minister of State or Central Government, the same shall be charged to tax under the head "Salaries". Pension received by an assessee from his former employer is taxable as "Salaries" whereas pension received on his death by members of his family (Family Pension) is taxed as "Income from other sources".

Section 17(1) of the Income tax Act gives an inclusive and not exhaustive definition of Salaries. "Salary" includes:

1. ***Wages or Salary:*** 'Salary' is generally used in respect of payment for services of a higher class, whereas 'wages' is confined to the earnings of labourers. However, for income-tax purposes there is no difference between salary and wages.

2. Annuity is annual grant made by the employer to the employee.
3. Pension is a periodical payment for past services.
4. Gratuity is a lump sum payment for past services.
5. ***Fees and Commission:*** It is a remuneration to encourage employees.
6. ***Perquisites:*** These include all benefits and amenities provided by the employer to the employee, either in cash or kind.
7. Profit in lieu of or in addition to salary or wages.
8. Advance of Salary.
9. Any payment received by an employee in respect of any period of leave not availed of by him.
10. ***Taxable Portion of Annual Accretion:*** Where the employee is a member of a Recognised Provident Fund, the amount contributed by the employer in this fund in excess of 12 per cent of the salary of the employee and interest credited on the amount of the fund in excess of the prescribed rate of interest is to be included in the salary income.
11. ***Taxable Portion of Transferred Balance:*** When an unrecognised provident fund is recognised for the first time, the balance in the unrecognised provident fund is known as "Transferred balance". The employer's share (contribution in unrecognised provident fund and interest on employer's share) is included in the salary income for income-tax purposes at the time of such transfer.
12. The contribution made by the Central Government in the previous year, the account of any employee under a pension scheme referred to in Section 80CCD.

Notes

1. Advance salary is taxable on receipt basis in the previous year in which it is received. The recipient can, however, claim relief under Section 89(1) read with Rule 21A.
2. Arrears salary is taxable on receipt basis subject to the fact that it has not been taxed on accrual basis earlier. The recipient can claim relief in terms of Section 89(1) read with Rule 21A.
3. Encashment of leave salary (before retirement) is taxable on receipt basis but relief can be claimed under Section 89(1). However, such salary received at the time of retirement is exempt subject to Section 10(10AA).
4. Pension received by a person from the employer after his retirement is taxed as salary. The pension can be either uncommuted or commuted. Commuted pensions received by government employees are wholly exempt under Section 10(10A). In case of non-Government employees, commuted value of one-third of pension which he is normally entitled to receive is exempt from tax if the employee receives gratuity. In other cases, one-half of commuted value of pension is exempt.
5. Instalments re-paid under Additional Emoluments (C.D.) Act, 1974 are taxable as arrear of salary in the previous year in which the same are received. However, relief under Section 89(1) can be claimed.

Self Assessment

Fill in the blanks:

1. ……………………..is the remuneration received by or accruing to an individual, periodically, for service rendered as a result of an express or implied contract.
2. The salary received by a partner from his partnership firm carrying on a business is not chargeable as…………………..
3. …………………..is confined to the earnings of labourers.
4. ………………………is annual grant made by the employer to the employee.

7.2 Basis of Charge of Salary

As per Section 15, the income chargeable to income tax under the head salaries would include:

1. Any salary due to an employee from an employer or a former employer during the previous year irrespective of the fact whether it is paid or not.
2. Any salary paid or allowed to the employee during the previous year by or on behalf of an employer, or former employer, would be taxable under this head even though such amounts are not due to him during the accounting year.
3. Arrears of salary paid or allowed to the employee during the previous year by or on behalf of an employer or a former employer would be chargeable to tax during the previous year in cases where such arrears were not charged to tax in any earlier year.

Caution However it would not include:

1. Any salary paid in advance and included in the total income of any person for any previous year, shall not be included again in the total income of the person when the salary becomes due.
2. Any salary, bonus, commission or remuneration, by whatever name called, due to, or received by, a partner of a firm from the firm shall not be regarded as "salary" for the purposes of this section.

Section 17 of the Act gives an inclusive definition of salary. Broadly, it includes:

1. Basic salary
2. Fees, Commission and Bonus
3. Taxable value of cash allowances
4. Taxable value of perquisites
5. Retirement Benefits

Although, all the components of salary income are included in salary, there are certain incomes in each of these categories, which are either fully exempt or exempt upto a certain limit. The aggregate of the above incomes, after the exemption(s) available, if any, is known as 'Gross Salary'. From the 'Gross Salary', the following three deductions are allowed under Section 16 of the Act to arrive at the figure of Net Salary:

1. Standard deduction - Section 16 (i)

2. Deduction for entertainment allowance – Section 16 (ii)
3. Deduction on account of any sum paid towards tax on employment – Section 16(iii).

Task Identify key words and ingredients for an income to be considered as salary under the Act.

7.2.1 Due Basis of Taxation

The basis of taxation of income from salary is normally on 'due' basis. Thus, salary due to an employee is taxable regardless of the fact whether he actually receives it or not. Exceptions to this rule are of cases where salary is received in advance by an employee which is chargeable to tax as and when it is received although the salary is not due to him.

But in order to ensure that there is no double taxation of the same item of income in the hands of the same employee, the explanation to Section 15 specifically provides that where an item of a salary income received by an employee in advance is taxed as and when it is received, it shall not again be charged to tax when it becomes due to the assessee. In order to attract liability to tax under this head, it is not essential that the employee, who is liable to tax under this head, must receive salary from his present employer.

Example: Rama is an employee of Tara Pvt. Ltd. getting a salary of ₹ 40,000 per month which becomes due on the last day of the month but is paid on the 7th of next month. Salary for which months will be taxable for AY 2013–14?

Solution: The salary for the months of April 2012 to March 2013 will be taxable for the Assessment Year 2013–14 because salary for April 2012 will be due on 30th April, 2012 (i.e. within the same month).

Example: Mr. Y is an employee of Y Ltd. His salary is ₹ 25,000 per month. Salary becomes due on last day of each month. In March, 2013, he received salary of April and May in Advance. Compute taxable amount for AY 2013–14 and AY 2014–15.

Solution: Taxable Salary for AY 2013–14 (PY 2012–13):

Salary for the months of April, 2012 to March, 2013 will be taxable on due basis.

Salary for the month of April 2013 and May, 2014 will also be taxable on receipt basis. It will not be taxable then in AY 2014–15 on receipt basis.

Thus, taxable salary for AY 2013–14 = ₹ 25,000×12 + ₹ 25,000×2 = ₹ 3,50,000

Taxable Salary for AY 2014–15 (PY 2013–14):

Salary for the month of June, 2014 to March, 2015 will only be taxable on due basis. Salary for April and May 2014 will not be taxable as that has already been taxed on receipt basis in the AY 2013–14.

Thus, taxable salary for AY 2014–15 = 25,000×10 = 2, 50,000

7.2.2 Employer and Employee Relationship

The salary of an employee is a separate source, distinct from other classes of income. The basis of liability under the head salaries is the employer-employee relationship. Before charging the particular income received by a person under this head, care must be taken to ensure that there exists such a relationship of employer and employee between the recipient and the payer of the income. The payments chargeable under the head salaries must be made between the persons who are in the relationship of employer and employee. Therefore, the amount received by an individual shall be treated as salary only if the relationship between payer and payee is of an employer and employee or master and servant. Employer may be an individual, firm, and association of persons, company, corporation, Central Government, State Government, public body or a local authority. Likewise, employer may be operating in India or abroad. The employee may be full time employee or part-time employee.

The question whether a particular person receives the income in his capacity as an employee or not has to be decided from the facts of each case.

Let's examine the following cases, whether payments are chargeable under head salaries;

1. The professor of university would be receiving income by way of monthly salary from the university which is chargeable to tax under this head. But this does not mean that every item of income received by the employee from his employer would be taxable under this head. Thus, income by way of examinership fees received by a professor from the same university in which he is employed would not be chargeable to tax under this head but must be taxed as Income from other sources under Section 56. This is because of the fact that the essential condition that the income in question must be received for services rendered in the ordinary course of employment would not be fulfilled in the case of examinership fees.

2. A director of a company may, in some cases, be an employee of a company where there is a specific contract of employment between him and the company. The fact that the same person has dual capacity in his relationship with the company does not mean that he cannot be taxed under this head. Every item of income arising to such a director who is also an employee of the company (e.g. a managing director or other whole-time director) by virtue of his employment would be taxable as his income from salary. Thus, income by way of remuneration received by a managing director would be taxable as his salary income whereas the income received by him as director's fees in his capacity as director for attending the meetings of the Board would be assessable under the head "Income from other sources".

3. An official liquidator appointed by the Court or by the Central Government would also become an employee of the Central Government under Section 448 of the Companies Act, 1956 and consequently the remuneration due to him would also be assessable under the head 'Salaries'.

4. Remuneration received by a manager of a company even if he is wrongly designated as a director or by any other name would be chargeable to tax under this head regardless of the fact that the amount is payable to him monthly or is calculated at a certain percentage of the company's profits.

5. Salary paid to a partner by a firm is nothing but appropriation of profits. Any salary, bonus, commission, or remuneration by whatever name called due to or received by partner of a firm shall not be regarded as salary but has to be charged as income from business. It is because of the fact that the relationship between the firm and its partner is not of employer and employee.

6. According to a circular of the Board dated 22-5-1967, the salary received by a person as Member of Parliament will not be chargeable to income-tax under the head "Salaries" but as "Income from other sources" because a Member of Parliament is not an employee of the Government but only an elected representative of the people.

7. The income received by a treasurer of a bank would be taxable as his salary income if the treasurer is an employee of the bank. If he does not happen to be an employee, the income received by him would be taxable as "Income from other sources". For this purpose, the question whether in a particular case the treasurer is an employee or not has to be decided on the basis of the facts and circumstances of each case having due regard to his powers, responsibilities and functions.

8. Income derived by any person from carrying on a profession or vocation must be taxed as business income and not as salary income because employment is different from profession.

But, if an employee receives any money from his employer as part of the terms of employment for not carrying on any profession, such income must be taxed as salary income. For instance, the allowance given by employer to a doctor employed by him for not carrying on a profession in addition to the employment would be income arising from employment in accordance with the terms and conditions of such employment and must, therefore, be taxed as salary income. If an employee gets money from persons other than his employer and if such money is not in any way related to the contract of services with the employer under whom he is working, the receipts, if taxable as income, must be assessed under the head "Income from other sources".

However, gratuity, bonus, commission or other items of payment made by the employer without any specific stipulation in the contract of employment to this effect, would still be taxable as salary, because they are paid by the employer for the services rendered by the employee. The fact is that such payments are voluntary and in certain circumstances may qualify for exemption from income-tax in the hands of the employee, would not affect the income being computed under the head salary.

Did u know? **Salary Received from Former Employer**

Even salaries received by an employee from former employer(s) for services rendered would be chargeable to tax under this head. Hence, the fact that the employee in question is not an employee under the person from whom the money is received at the time of its receipt is irrelevant. Arrears of salaries are chargeable to tax as the income of the year in which such arrears are received if they are not charged to tax at the time of becoming due.

7.2.3 Other Points for Consideration for Taxability of Salary

The following points should be kept in mind while computing Income under the Salaries:

1. Any lump sum amount paid to an employee by his employer in commutation, reduction or substitution of salary, pension or other type of income from employment is nevertheless taxable as income from salary in the year in which such payment falls due or is received by the employee, whichever is earlier. Section 200 of the Companies Act totally prohibits any company from paying tax-free remuneration to any of its employees.

2. For purposes of computing the income taxable under this head, the gross salary due to the employee should be taken as the basis. Thus, any tax deducted at source or other deductions on account of provident fund, insurance premium, or on any other account made by the employer from the salary income, should be added to the net salary received by the employee. The fact that some of the deductions like provident fund or insurance premium may qualify for any deduction from gross total income in the personal assessment of the employee, does not, in any way, affect the quantum of salary due to the employee.

3. Any salary voluntarily surrendered by the employee on or after 1- 4-1961 to the Central Government under the provisions of the Voluntary Surrender of Salaries (Exemption

from Taxation Act), 1961, would not be treated as income taxable in the hands of the employee. In all other cases, the salary foregone voluntarily or otherwise surrendered by the employee would still be chargeable to tax although the employee may not receive that income. No tax exemption is available for surrender of salaries for the simple reason that the amount surrendered constitutes merely an application of income which is immaterial for the purpose of taxing the employee.

If the foregoing or surrender of salary represents a donation for charitable purpose, the employee may qualify for deduction from gross total income under Section 80G of the Act. However, salary foregone before it becomes due cannot be taxed. Further, where in reality there is no agreement to pay any salary, the apparent foregoing of a fictional salary would not attract tax.

4. Where a person, out of missionary spirit, agrees to work as principal in an institution without accepting any salary from the institution, and in the school accounts his salary is shown as an item of expenditure, while the same amount is entered in the receipts as a donation by the management in a separate cash book meant for exclusive use for the management only, these entries are book entries only and no money is actually paid to him; hence, taking into consideration the special circumstances of the case, the fictional salary would not be taxable.

5. Salary is taxable even if the money is not received or could not be recovered from the employer due to his insolvency or any other reason. The expenses, if any, incurred by the employee to take legal proceedings against his employer for its recovery would not also are allowed as a deduction from the income assessable in his hands. This is because of the fact that the actual receipt of the income is immaterial for purpose of its taxation.

6. It is immaterial whether the employer is Government or a private employer. Further, the salary may be paid by a foreign Government to its employees serving in India, and this salary is taxable under the head "Salaries".

7. The leave salary paid to the legal heirs of the deceased employee in respect of privilege leave standing to the credit of such employee at the time of his/her death is not taxable as salary. It is an ex-gratia payment on compassionate grounds in the nature of gift. Thus, the payment is not in the nature of a salary.

Caselet

Salary and Grade System in India

An employee may be entitled to receive salary in grade system in India. Under this system, the normal annual increments to be given to the employee are already fixed in the grade. If an employee joins the service on 1.6.2009 and is placed in the grade of 10,000-1,000-15,000-2,000-25,000 then his salary from 1.6.2009 will be 10,000 p.m. and thereafter his salary will be 11,000 p.m. w.e.f. 31.5.2010 until it reaches 15,000 after which it will increase annually by 2,000 until it reaches 25,000. After that, employee will be placed in another grade.

In certain cases, employee joins in the grade at a salary in between the grade, in that case his salary will annually increase in the aforesaid manner the only difference would be that his initial salary would be a different amount than the start of the grade.

A joins the service in the grade of 10,000-1000-15,000-2,000-25,000 on 1.8.2009 at a salary of 13,000. Compute taxable salary for AY 2013–14.

Contd...

Computation of his Taxable Salary for Previous Year 2012–13 (1-4-2012 to 31-3-2013) will be computed under grade system as:

Salary from 1.8.2009 to 31.7.2010: 13,000 p.m.

Salary from 1.8.2010 to 31.7.2011: 14,000 p.m.

Salary from 1.8.2011 to 31.7.2012: 15,000 p.m.

Salary from 1.8.2012 to 31.7.2013: 17,000 p.m.

Salary for Previous year 2012–13 will be divided into two parts:

Salary from 1.4.2012 to 31.7.2012 = 15,000 × 4 = 60,000

Salary from 1.8.2012 to 31.3.2013 = 17,000 × 8 = 1,36,000

Total Salary for P.Y. 2012–13 = 1,96,000

Self Assessment

State whether the following statements are true or false:

5. The basis of taxation of income from salary is normally on 'due' basis.
6. In order to attract liability to tax under the head salary, it is not essential that the employee, who is liable to tax under this head, must receive salary from his present employer.
7. The salary of an employee is a separate source which is not distinct from other classes of income.
8. Salaries received by an employee from former employer(s) for services rendered would not be chargeable to tax under the head salaries.

7.3 Allowances

An allowance is defined as a fixed amount of money given periodically in addition to the salary for the purpose of meeting some specific requirements connected with the service rendered by the employee or by way of compensation for some unusual conditions of employment. It is taxable on due or accrued basis whether it is paid in addition to the salary or in lieu thereon. Thus allowances are generally taxable and are to be included in gross salary unless specific exemption is provided in respect of such allowance. For the purpose of tax treatment, we divide these allowances into three categories:

- Fully taxable cash allowances
- Partially exempt cash allowances
- Fully exempt cash allowances

The three categories of allowances are briefly explained as follows:

7.3.1 Fully Taxable Allowances

This category includes all the allowances, which are fully taxable. So, if an allowance is not partially exempt or fully exempt, it gets included in this category.

The allowances which are fully taxable in the hands of employee are:

1. ***Dearness Allowance, Additional Dearness Allowance and Dearness Pay:*** This is a very common allowance these days on account of high prices. Sometimes Additional Dearness Allowance is also given. It is included in the income from salary and is taxable in full. Sometimes it is given under the terms of employment and sometimes without it. When it is given under the terms of employment it is included in salary for purposes of determining the exemption limits of house rent allowance, recognised provident fund, gratuity and value of rent free house and is also taken into account for the purposes of retirement benefits. Sometimes dearness allowance is given as 'Dearness Pay'. It means that it is being given under the terms of employment.
2. ***Fixed Medical Allowance:*** Medical allowance is fully taxable even if some expenditure has actually been incurred for medical treatment of employee or family.
3. ***Tiffin Allowance:*** It is a fully taxable allowance. It is given to employees for lunch as coupons or added as part of salary.
4. ***Servant Allowance:*** It is fully taxable even if it is given to a low paid employee, not being an officer, i.e., it is taxable for all categories of employees.
5. ***Non-practicing Allowance:*** It is generally given to those medical doctors who are in government service and they are banned from doing private practice. It is to compensate them for this ban. It is fully taxable.
6. ***Hill Allowance:*** It is given to employees working in hilly areas on account of high cost of living in hilly areas as compared to plains. It is fully taxable, if the place is located at less than 1,000 meters height from sea level.
7. ***Warden Allowance and Proctor Allowance:*** These allowances are given in educational institutions for working as Warden of the hostel and/or working as Proctor in the institution. These allowances are fully taxable.
8. ***Deputation Allowance:*** When an employee is sent from his permanent place of service to some other place or institution or organisation on deputation for a temporary period, he is given this allowance. It is fully taxable.
9. ***Overtime Allowance:*** When an employee works for extra hours over and above his normal hours of duty he is given overtime allowance as extra wages. It is fully taxable.
10. ***Other Allowances:*** Other allowances like Family allowance, Project allowance, Marriage allowance, City Compensatory allowance, Dinner allowance, Telephone allowance etc. These are fully taxable.

7.3.2 Partially Exempt Allowances

This category includes allowances which are exempt upto certain limit. For certain allowances, exemption is dependent on amount of allowance spent for the purpose for which it was received and for other allowances, there is a fixed limit of exemption.

1. ***House Rent Allowance (HRA):*** House Rent Allowance (HRA) is generally paid as component of salary package. This allowance is given by an employer to an employee to meet the cost of renting an accommodation. Section 10(13A) of the Income Tax Act provides for exemption of HRA based on certain rules. In order to claim HRA exemption, the following basic conditions should be met:
   - Assessee should be staying in a rented accommodation.

- The house should not be owned by him or his spouse
- Assessee should be paying the rent.

Exemption limit in HRA: Minimum of the following three is exempt:

1. Actual HRA received
2. Rent paid minus 10% of Salary
3. 50% of salary if you live in Mumbai, Delhi, Kolkata or Chennai, otherwise 40% of Salary

Caution Here Salary means Basic Salary + Dearness Allowance + Commission based on a fixed percentage of turnover achieved by employee. Most of the private sector companies don't have the last two components in the salary package.

An employee can claim exemption on his HRA under the Income Tax Act if he stays in a rented house and is in receipt of HRA from his employer. In order to claim the deduction, an employee must actually pay rent for the house which he occupies.

The rented premises must not be owned by him. In case one stays in an own house, nothing is deductible and the entire amount of HRA received is subject to tax.

Example: Anurag has a Basic Salary of ₹ 30,000 per month. For the year 2012–13 he received HRA amounting to ₹ 10,000 per month. He paid rent worth ₹ 8,000 per month. His House is located in Chennai. In this case the HRA exemption that can be claimed by Anurag is:

Solution:

Minimum of following will be exempt,

1. HRA actually received: ₹ 1,20,000
2. Rent less 10% of Salary: ₹ 96,000 – (10% of 3,60,000): ₹ 60,000
3. 50% of Salary: ₹ 1,80,000

Working Notes:

Actual HRA received = 10,000 × 12 = ₹ 1,20,000

Salary = 30,000 × 12 = 3,60,000. No DA and Commission details given.

Rent Paid = 8,000 × 12 = 96,000

Thus ₹ 60,000 HRA is exempt and balance ₹ 60,000 HRA is taxable.

Example: Ankush is entitled to a basic salary of ₹ 5,000 per month and a DA of ₹ 1,000 per month, 40% of which forms part of retirement benefit. He is also entitled for House Rent Allowance of ₹ 2,000 per month. He actually pays ₹ 2,000 per month as rent of the house in Delhi.

Solution:

In this example the exemption limit for HRA can be calculated as:

Salary (5,000 × 12) = 60,000

DA (40% of 12,000) = 4800

Total Salary for computation of HRA = 64800

Now minimum of the three amounts shall be exempt from tax:

1.	Actual HRA received	24,000
2.	Rent Paid minus 10% of salary (24,000 – 6480)	17,520
3.	50% of Salary	32,400

Therefore ₹ 17,520 shall be HRA exempt and the balance 6480 shall be included in total gross salary.

2. ***Entertainment Allowance (EA):*** In case of Entertainment allowance an assessee will not get any exemption but would be eligible for deduction under section 16(ii) from gross salary. The deduction is allowed to government employees only; Non- Government employees will not be eligible for this deduction. The entire amount of entertainment allowance will be added to gross salary.

   The minimum of the following shall be available as deduction in case of Government employees:

   (a) Actual amount of entertainment allowance received during the year

   (b) 20% of his salary exclusive of any allowance, benefit or other perquisites.

   (c) ₹ 5,000.

Caution In order to determine amount of entertainment allowance deductible from salary, the following points need consideration:

- For this purpose "salary" excludes any allowance, benefit or other perquisites.
- Amount actually expended towards entertainment (out of entertainment allowance received) is not taken into consideration.
- In the case of a non-Governmental employee (including employees of statutory corporation and local authority), entertainment allowances is not deductible, and are completely chargeable to tax.

Example: Ram who is an employee of AP government gets a salary of ₹ 5,00,000 per annum. He gets a sum of ₹ 15,000 annually as entertainment allowance. The Actual expense incurred by him on entertainment is ₹ 12,000.

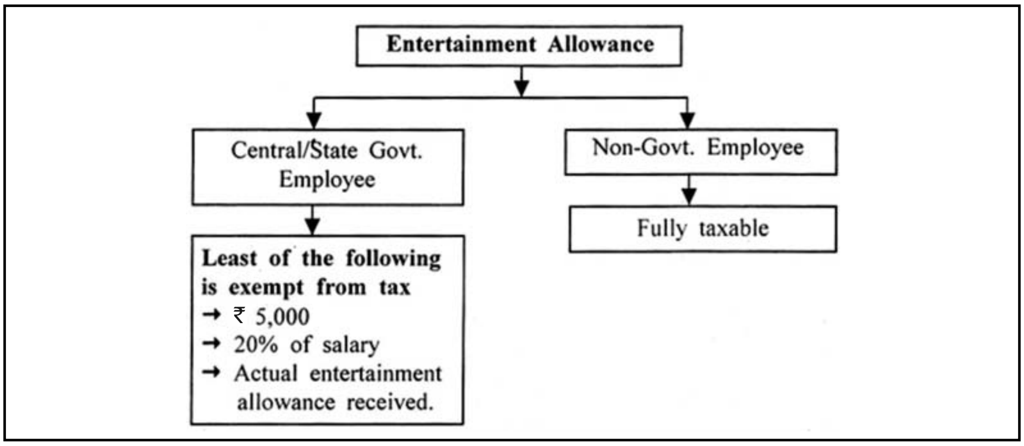
Solution:

In this case as Ram is a government employee, he is exempted from EA. Such exemption is calculated as under.

The least of the following is exempted:

1.	Actual amount of entertainment allowance received during the year	15,000
2.	20% of his salary (20% of 5,00,000)	1,00,000
3.	The amount of	5,000

Therefore in the above case the minimum out of the above three is ₹ 5,000 and u/s 16(ii) this amount will be the exempted amount of EA.



Source: http://www.incometaxmanagement.com/Pages/Graphical-ITax/Entertainment-Allowance-Salary.html

Caution Entertainment allowance first included in the salary income under the head of Salaries and after that dedication is provided as per above limit.

3. ***Special Allowances for Meeting Official Expenditure:*** These allowances are specifically granted to meet expenses wholly and exclusively incurred in the performance of official duty. These are exempt to the extent such expenses are actually incurred or the amount received whichever is less. These allowances are Travelling allowance, Daily allowance, Helper allowance, Academic allowance, Uniform allowance etc.

4. ***Special Allowances to Meet Personal Expenses:*** There are certain allowances given to the employees for specific personal purposes and the amount of exemption is fixed i.e. not dependent on actual expenditure incurred in this regard. These allowances include:

   (a) *Children Education Allowance:* This allowance is exempt to the extent of ₹ 100 per month per child for maximum of 2 children.

   (b) *Children Hostel Allowance:* Any allowance granted to an employee to meet the hostel expenditure on his child is exempt to the extent of ₹ 300 per month per child for maximum of 2 children.

   (c) *Transport Allowance:* This allowance is generally given to government employees to compensate the cost incurred in commuting between place of residence and place of work. An amount upto ₹ 800 per month paid is exempt. However, in case of blind and orthopaedically handicapped persons, it is exempt up to ₹ 1,600 p.m.

   (d) *Out of Station Allowance:* An allowance granted to an employee working in a transport system to meet his personal expenses in performance of his duty in the course of running of such transport from one place to another is exempt upto 70% of such allowance or ₹ 6,000 per month, whichever is less.

7.3.3 Fully Exempt Allowances

Some of the allowances which are fully exempted from tax in hands of employee are:

1. ***Foreign Allowance:*** This allowance is usually paid by the government to its employees being Indian citizen posted out of India for rendering services abroad. It is fully exempt from tax.

Notes

2. Allowance to High Court and Supreme Court Judges of whatever nature are exempt from tax.

3. Allowances from UNO organisation to its employees are fully exempt from tax

Example: From the following particulars, compute gross salary of Mr. X for the assessment year 2013–14. He is employed in textile industry in Mumbai at a monthly salary of ₹ 4,000. He is entitled to commission of 1% on sales achieved by him, which were ₹ 10 lakh for the year.

In addition, he received the following allowances from the employer during the previous year:

1. Dearness Allowance ₹ 2,000 per month which is granted under terms of employment and counted for retirement benefits.
2. Bonus ₹ 32,000
3. House Rent Allowance ₹ 1,000 per month (Rent paid for house in Mumbai ₹ 1,200 per month)
4. Entertainment Allowance ₹ 1,000 per month
5. Children Education Allowance ₹ 500 per month
6. Transport Allowance ₹ 1,000 per month
7. Medical Allowance ₹ 500 per month
8. Servant Allowance ₹ 200 per month
9. City Compensatory Allowance ₹ 300 per month
10. Research Allowance ₹ 500 per month (amount spent on research ₹ 3,000)

Solution:

Computation of Income from Salary of Mr. X for the Assessment Year 2013–14.

Basic Salary	48,000
Dearness Allowance	24,000
Commission	10,000
Bonus	32,000
House Rent Allowance	
(₹ 1,000 × 12 – Amount exempts ₹ 6,200)*	5,800
Entertainment Allowance	12,000
Children Education Allowance	
(₹ 500 × 12 – Amount exempt ₹ 100 × 2 × 12)	3,600
Transport Allowance	
(₹ 1,000 × 12 – Amount exempt ₹ 800 × 12)	2,400
Medical Allowance (fully taxable)	6,000
Servant Allowance (fully taxable)	2,400
City Compensatory Allowance (fully taxable)	3,600
Research Allowance	
(₹ 500 × 12 – Amount exempt ₹ 3,000)	3,000

Gross Salary: 1,52,800

* Amount of HRA exempt is least of 3 amounts

(a) 50% of Salary (Basic Salary + DA granted under terms of employment + Commission based on percentage of turnover – ₹ 48,000 + ₹ 24,000 + ₹ 10,000 = ₹ 82,000) = ₹ 41,000

(b) Actual HRA received: ₹ 1000 × 12 = ₹ 12, 000

(c) Rent paid (₹ 1200 × 12) – 10% of Salary (₹ 82,000) ₹ 14,400 – ₹ 8,200 = ₹ 6,200

Task Classify these allowances into the following three categories:

Project allowance, Out of station allowance, Dearness allowance, Servant allowance, Hostel allowance, Uniform allowance, Dress allowance, Marriage allowance, Foreign allowance, overtime allowance:

1. Fully taxable allowances
2. Partially exempt allowances
3. Fully exempt allowances

Self Assessment

Fill in the blanks:

9. ....is defined as a fixed amount of money given periodically in addition to the salary for the purpose of meeting some specific requirements connected with the service rendered by the employee or by way of compensation for some unusual conditions of employment.

10. Allowances are generally taxable and are to be included in .... unless specific exemption is provided in respect of such allowance.

11. .... is a very common allowance these days on account of high prices.

12. .... is given to employees for lunch as coupons or added as part of salary.

7.4 Perquisites

Perquisites are defined as any casual emolument or benefit attached to an office or position in addition to salary or wages. It denotes something that benefits a man by going into his pocket; it does not cover mere re-imbursement of necessary disbursements. Such benefits are normally given in kind but should be capable of being measurable in money terms. Perquisites are taxable and included in gross salary only if they are (i) allowed by an employer to an employee, (ii) Allowed during the continuation of employment, (iii) directly dependent on service, (iv) resulting in the nature of personal advantage to the employee and (v) derived by virtue of employer's authority.

As per Section 17 (2) of the Act, perquisites include:

1. Value of rent free accommodation provided to the employee by the employer.

2. Value of concession in the matter of rent in respect of accommodation provided to the employee by his employer.

3. Value of any benefit or amenity granted free of cost or at a concessional rate in any of the following cases:
   (a) by a company to an employee who is a director there of
   (b) by a company to an employee who has substantial interest in the company
   (c) by any employer to an employee who is neither a director, nor has substantial interest in the company, but his monetary emoluments under the head 'Salaries' exceeds ₹ 50,000.
4. Any sum paid by the employer towards any obligation of the employee.
5. Any sum payable by employer to affect an assurance on the life of assessee.
6. The value of any other fringe benefit given to the employee as may be prescribed.

For tax purposes, perquisites specified under Section 17(2) of the Act may be classified as follows:

1. Perquisites that are taxable in case of every employee, whether specified or not.
2. Perquisites that is taxable in case of specified employees only.
3. Perquisites those are exempt from tax for all employees.

Did u know? The term "Perquisite" is defined by section 17(2) as follows:

1. the value of rent-free accommodation provided to the assessee by his employer;
2. the value of any concession in the matter of rent respecting any accommodation provided to the assessee by his employer;

Explanation 1: For the purposes of this sub-clause, concession in the matter of rent shall be deemed to have been provided if:

(a) in a case where an unfurnished accommodation is provided by any employer other than the Central Government or any State Government and –
   (i) the accommodation is owned by the employer, the value of the accommodation determined at the specified rate in respect of the period during which the said accommodation was occupied by the assessee during the previous year, exceeds the rent recoverable from, or payable by, the assessee;
   (ii) the accommodation is taken on lease or rent by the employer, the value of the accommodation being the actual amount of lease rental paid or payable by the employer or fifteen per cent of salary, whichever is lower, in respect of the period during which the said accommodation was occupied by the assessee during the previous year, exceeds the rent recoverable from, or payable by, the assessee;

(b) in a case where a furnished accommodation is provided by the Central Government or any State Government, the licence fee determined by the Central Government or any State Government in respect of the accommodation in accordance with the rules framed by such Government as increased by the value of furniture and fixtures in respect of the period during which the said accommodation was occupied by the assessee during the previous year, exceeds the aggregate of the rent recoverable from, or payable by, the assessee and any charges paid or payable for the furniture and fixtures by the assessee;

(c) in a case where a furnished accommodation is provided by an employer other than the Central Government or any State Government and –
   (i) the accommodation is owned by the employer, the value of the accommodation determined under sub-clause (i) of clause (a) as increased by the value of the furniture

Notes

and fixtures in respect of the period during which the said accommodation was occupied by the assessee during the previous year, exceeds the rent recoverable from, or payable by, the assessee;

(ii) the accommodation is taken on lease or rent by the employer, the value of the accommodation determined under sub-clause (ii) of clause (a) as increased by the value of the furniture and fixtures in respect of the period during which the said accommodation was occupied by the assessee during the previous year, exceeds the rent recoverable from, or payable by, the assessee;

(d) in a case where the accommodation is provided by the employer in a hotel (except where the assessee is provided such accommodation for a period not exceeding in aggregate fifteen days on his transfer from one place to another), the value of the accommodation determined at the rate of twenty-four per cent of salary paid or payable for the previous year or the actual charges paid or payable to such hotel, whichever is lower, for the period during which such accommodation is provided, exceeds the rent recoverable from, or payable by, the assessee.

Explanation 2: For the purposes of this sub-clause, value of furniture and fixture shall be ten per cent per annum of the cost of furniture (including television sets, radio sets, refrigerators, other household appliances, air-conditioning plant or equipment or other similar appliances or gadgets) or if such furniture is hired from a third party, the actual hire charges payable for the same as reduced by any charges paid or payable for the same by the assessee during the previous year.

Explanation 3: For the purposes of this sub-clause, "salary" includes the pay, allowances, bonus or commission payable monthly or otherwise or any monetary payment, by whatever name called, from one or more employers, as the case may be, but does not include the following, namely:

(a) dearness allowance or dearness pay unless it enters into the computation of superannuation or retirement benefits of the employee concerned;

(b) employer's contribution to the provident fund account of the employee;

(c) allowances which are exempted from the payment of tax;

(d) value of the perquisites specified in this clause;

(e) any payment or expenditure specifically excluded under the proviso to this clause.]

Explanation 4: For the purposes of this sub-clause, "specified rate" shall be –

(i) fifteen per cent of salary in cities having population exceeding twenty-five lakhs as per 2001 census;

(ii) ten per cent of salary in cities having population exceeding ten lakhs but not exceeding twenty-five lakhs as per 2001 census; and

(iii) seven and one-half per cent of salary in any other place;

(iv) the value of any benefit or amenity granted or provided free of cost or at concessional rate in any of the following cases:

(a) by a company to an employee who is a director thereof;

(b) by a company to an employee being a person who has a substantial interest in the company;

(c) by any employer (including a company) to an employee to whom the provisions of paragraphs (a) and (b) of this sub-clause do not apply and whose income under the head "Salaries" (whether due from, or paid or allowed by, one or more employers), exclusive of the value of all benefits or amenities not provided for by way of monetary payment, exceeds fifty thousand rupees

Caution For the removal of doubts, it is hereby declared that the use of any vehicle provided by a company or an employer for journey by the assessee from his residence to his office or other place of work, or from such office or place to his residence, shall not be regarded as a benefit or amenity granted or provided to him free of cost or at concessional rate for the purposes of this sub-clause;

(v) any sum paid by the employer in respect of any obligation which, but for such payment, would have been payable by the assessee;

(vi) any sum payable by the employer, whether directly or through a fund, other than a recognised provident fund or an approved superannuation fund or a Deposit-linked Insurance Fund established under section 3G of the Coal Mines Provident Fund and Miscellaneous Provisions Act, 1948 (46 of 1948), or, as the case may be, section 6C of the Employees' Provident Funds and Miscellaneous Provisions Act, 1952 (19 of 1952)], to effect an assurance on the life of the assessee or to effect a contract for an annuity;

(vii) the value of any specified security or sweat equity shares allotted or transferred, directly or indirectly, by the employer, or former employer, free of cost or at concessional rate to the assessee.

Notes For the purposes of this sub-clause:

(a) "specified security" means the securities as defined in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956) and, where employees' stock option has been granted under any plan or scheme therefor, includes the securities offered under such plan or scheme;

(b) "sweat equity shares" means equity shares issued by a company to its employees or directors at a discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called;

(c) the value of any specified security or sweat equity shares shall be the fair market value of the specified security or sweat equity shares, as the case may be, on the date on which the option is exercised by the assessee as reduced by the amount actually paid by, or recovered from, the assessee in respect of such security or shares;

(d) "fair market value" means the value determined in accordance with the method as may be prescribed;

(e) "option" means a right but not an obligation granted to an employee to apply for the specified security or sweat equity shares at a predetermined price;

(viii) the amount of any contribution to an approved superannuation fund by the employer in respect of the assessee, to the extent it exceeds one lakh rupees; and the value of any other fringe benefit or amenity as may be prescribed:

Provided that nothing in this clause shall apply to:

(i) the value of any medical treatment provided to an employee or any member of his family in any hospital maintained by the employer;

(ii) any sum paid by the employer in respect of any expenditure actually incurred by the employee on his medical treatment or treatment of any member of his family:

(a) in any hospital maintained by the Government or any local authority or any other hospital approved by the Government for the purposes of medical treatment of its employees;

(b) in respect of the prescribed diseases or ailments, in any hospital approved by the Chief Commissioner having regard to the prescribed guidelines:

Provided that, in a case falling in sub-clause (b), the employee shall attach with his return of income a certificate from the hospital specifying the disease or ailment for which medical treatment was required and the receipt for the amount paid to the hospital;

(iii) any portion of the premium paid by an employer in relation to an employee, to effect or to keep in force an insurance on the health of such employee under any scheme approved by the Central Government or the Insurance Regulatory and Development Authority established under sub-section (1) of section 3 of the Insurance Regulatory and Development Authority Act, 1999 (41 of 1999),] for the purposes of clause (ib) of sub-section (1) of section 36

(iv) any sum paid by the employer in respect of any premium paid by the employee to effect or to keep in force an insurance on his health or the health of any member of his family under any scheme approved by the Central Government or the Insurance Regulatory and Development Authority established under sub-section (1) of section 3 of the Insurance Regulatory and Development Authority Act, 1999 (41 of 1999), for the purposes of section 80D

(v) any sum paid by the employer in respect of any expenditure actually incurred by the employee on his medical treatment or treatment of any member of his family [other than the treatment referred to in clauses (i) and (ii)]; so, however, that such sum does not exceed fifteen thousand rupees in the previous year;

(vi) any expenditure incurred by the employer on:

(a) medical treatment of the employee, or any member of the family of such employee, outside India;

(b) travel and stay abroad of the employee or any member of the family of such employee for medical treatment;

(c) travel and stay abroad of one attendant who accompanies the patient in connection with such treatment, subject to the condition that—

- the expenditure on medical treatment and stay abroad shall be excluded from perquisite only to the extent permitted by the Reserve Bank of India; and

- the expenditure on travel shall be excluded from perquisite only in the case of an employee whose gross total income, as computed before including therein the said expenditure, does not exceed two lakh rupees;

(vii) any sum paid by the employer in respect of any expenditure actually incurred by the employee for any of the purposes specified in clause (vi) subject to the conditions specified in or under that clause:

Provided further that for the assessment year beginning on the 1st day of April, 2002, nothing contained in this clause shall apply to any employee whose income under the head "Salaries" (whether due from, or paid or allowed by, one or more employers) exclusive of the value of all perquisites not provided for by way of monetary payment, does not exceed one lakh rupees.

Explanation: For the purposes of clause (2):

(i) "hospital" includes a dispensary or a clinic or a nursing home;

(ii) "family", in relation to an individual, shall have the same meaning as in clause (5) of section 10; and

(iii) "gross total income" shall have the same meaning as in clause (5) of section 80B;

Self Assessment

Fill in the blanks:

13. ....includes all benefits and amenities provided by the employer to the employee in addition to salary and wages either in cash or in kind which are convertible into money.

14. ....means the securities as defined in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956) and, where employees' stock option has been granted under any plan or scheme therefor, includes the securities offered under such plan or scheme.

15. .... means the value determined in accordance with the method as may be prescribed.

16. .... means a right but not an obligation granted to an employee to apply for the specified security or sweat equity shares at a predetermined price.

7.5 Types of Perquisites

Perquisites are broadly categorised into tax-free perquisites, taxable perquisites and perquisites taxable under specified cases. Let us now discuss each one of these in detail.

7.5.1 Tax-free Perquisites

The value of the following perquisites is not to be included in the salary income of an employee:

1. ***Medical facilities:*** It includes the following:

   (a) The value of any Medical facility provided to an employee or his family member in any hospitals, clinics, etc. maintained by the employer.

   (b) Reimbursement of expenditure actually incurred by the employee on medical treatment for self or for his family members in any hospitals, dispensaries etc. maintained by the Government or local authority or in a hospital approved under the Central Health Scheme or any similar scheme of the state Government or in a hospital, approved by the chief commissioner having regard to the prescribed guidelines for the purposes of medical treatment of the prescribed diseases or ailments.

   (c) Group medical insurance obtained by the employer for his employees (including family members of the employees) or all medical insurance payments made directly or reimbursement of insurance premium to such employees who take such insurance.

(d) Reimbursement of medical expenses actually incurred by the employee upto a maximum of ₹ 15,000 in the aggregate in a year, in a private hospital for his and his family.

(e) Any expenditure incurred or paid by the employer on the medical treatment of the employee or any family member of the employee outside India, the travel and stay abroad of such employee or any family member of such employee or any travel or stay abroad of one attendant who accompanies the patient in connection with such treatment will not be included in perquisites of the employee.

Caution However, the travel expenditure shall be excluded from the perquisites only when the employee's gross total income as computed before including the said expenditure does not exceed two lakh rupees and further to such conditions and limits as the Board may prescribe having regard to guidelines, if any, issued by the Reserve Bank of India.

2. ***Refreshment:*** The value of refreshment provided by the employer during office hours and in office premises is fully exempt. Free Meals provided by the employer during working or business hours or through paid non-transferable (usable only at eating joints) voucher if its value thereof in either case does not exceed ₹ 50 will not be treated as income of the employee.

Notes Free meals provided by the employer during working hours in a remote area or an offshore installation shall be fully exempt.

3. ***Subsidized lunch or dinner provided by employer:*** With effect from assessment year 1996–97, expenditure incurred by employer on provision of food or beverages to employees either inside or outside the place of work during working hours upto ₹ 35 per day per employee will not be treated as income of the employee provided the amount is paid by the employer directly to the caterer, restaurant, eating place, canteen, etc.

4. ***Recreational facilities:*** The value of recreational facilities provided is exempt. However, the facility should not be restricted to a selected few.

5. ***Telephone facility:*** Telephone facility provided at the residence of the employee is exempt to the extent of the amount of telephone bills paid by the employer when it is used for official and personal purposes of the employee.

6. ***The value of transport:*** The value of transport provided by the employer to the employees as a group (and not to any individual or a few employees alone) from their place of residence to the place of work and back in the case of an employer engaged in the business of carriage of goods or passengers, to his employees either free of charge or at a concessional rate. Also from the assessment year 1990–91, conveyance facility provided for the journey between office and residence and back at free of charge or at concessional rate.

7. ***Personal accident insurance:*** Payment of annual premium by employer on personal accident policy affected by him to his employee.

8. ***Refresher course:*** Where the employee attends any refresher course in management and the fees are paid by the employer, the amount spent by employer for the purpose.

9. ***Free rations:*** The value of free rations given to the armed forces personnel.

10. ***Family planning:*** The amount spent by an employer on the promotion of family planning amongst its employees.

11. Sale of an asset (being a movable asset but other than car, electronic items) or gift of such asset to an employee after using the same by the employer for 10 years or more is a perquisite in the hands of employee.
12. Perquisites to Government employees being citizens of India, posted abroad.
13. ***Rent-free house to High Court Judges*** [High Court Judges (Conditions of Service) Act, 1954].
14. ***Rent-free house to Supreme Court Judges*** [Supreme Court Judges (Conditions of Service) Act, 1958].
15. Conveyance facility to High Court and Supreme Court judges.
16. ***Privilege*** passes and privilege ticket orders granted by Railways to its employees.
17. Sum payable by an employer through a Recognised Provident Fund or an Approved Superannuation Fund or Deposit-linked Insurance Fund established under the Coal Mines Provident Fund or the Employees' Provident Fund.
18. Sum payable by an employer to pension or deferred annuity scheme.
19. Employer's contribution to staff group insurance scheme.
20. Actual travelling expenses paid/reimbursed by the employer for journeys undertaken by employees for business purposes.
21. Leave travel concession exempt as per provision of Section 10.
22. Free holiday trips to non-specified employees.
23. Rent-free furnished residence (including maintenance thereof) provided to an Officer of Parliament, a Union Ministry and a leader of opposition in Parliament.
24. Goods sold to employees, by their employer, at concessional rates.
25. The value of any benefit provided by a company free of cost or at a concessional rate to its employees by way of allotment of shares, debentures or warrants directly or indirectly under the Employees' Stock Option Plan or Scheme of the said company.
26. Free educational facility to the children of the employee in an educational institute owned or maintained by the employer if cost of such education or value of such benefit does not exceed 1,000/- per month per child.
27. Interest free loan to an employee if the amount of loan does not exceed 20,000/- or if loan is provided for specified diseases.
28. Computer or laptops (provided only for use, ownership is retained by the employer).

Caution One cannot be said to allow a perquisite to an employee if the employee has no right to the same. It cannot apply to contingent payment to which the employee has no right till the contingency occurs.

7.5.2 Taxable Perquisites (In all Cases)

The value of the following perquisites is added to the salary income of the employee:

1. Value of rent-free residential accommodation provided to the assessee (except to the Judge of a High Court or Supreme Court; an Officer of Parliament, a Union Minister and a leader of opposition in Parliament).

Notes

2. Value of any concession in the matter of rent in respect of residential accommodation provided to the assessee.

3. Sum paid by the employer (directly or indirectly) for affecting an assurance on the life of the employee or for providing an annuity. If the amount is paid to a recognised provident fund or an approved superannuation fund, or to a deposit linked insurance fund established under the Coal Mines Provident Fund Act or Employees' Provident Fund Act, the sum so paid is not to be included in the salary income.

4. Sum paid by the employer in respect of any obligation of the assessee, which would otherwise have been payable by the assessee. Some of the examples of such expenses are as follows:

   a) Income-tax paid by the employer due from the employee.

   b) Payment of club bills, club subscription or hotel bills of the employee.

   c) Fees paid by the employer directly to the school or reimbursement of tuition fees of the children of the employee.

   d) Payment of any loan due to the employee.

5. The value of any specified security or sweat equity shares allotted or transferred, directly or indirectly, by the employer, or former employer, free of cost or at concessional rate to the assessee.

6. The amount of any contribution to an approved superannuation fund by the employer in respect of the assessee, to the extent it exceeds one lakh rupees.

7. The value of any other fringe benefit or amenity as may be prescribed.

Example: Some other examples of taxable perquisites are as follows:

(a) Any reward awarded. For instance, a professional jockey receives present from his employer on winning the race.

(b) Any legal charges incurred by the employer to save or defend the employee. For instance, if an employee knocks down a pedestrian during the course of employment or otherwise while driving the company's car due to his negligence and, to defend his case in the court, the employer incurs heavy expenses, the amount spent by him on this account would represent a perquisite. It is likely that the actual expenditure incurred by the employer might be much larger than what the employee himself would have done if he were to take up the proceedings himself. Even in such cases, the perquisite chargeable to tax would be the entire amount spent by the employer and not only a portion thereof which the employee would have spent if he had himself taken up the legal proceedings in the court. Thus, the cost of legal defence of a criminal charge or civil litigation expenses incurred by the employer on behalf of the employee even in his own interest for the purpose of retaining the services of the employee would be taxable as perquisite.

7.5.3 Perquisites Taxable only in the Cases of Specified Employees

The value of certain benefit or amenity granted or provided free of cost or at a concessional rate in any of the following cases only shall be included in the salary income:

(a) by a company to an employee who is director thereof

(b) by a company concern to an employee, being a person who has a substantial interest in the company concern, i.e., employee is the beneficial owner of at least 20 per cent of the equity shares of that company or is entitled to at least 20 per cent share is profit of the concern;

(c) an employee whose income chargeable under head salaries (exclusive of the value of all benefits or amenities not provided by way of monetary payments) excess 50,000, is a specified employed.

Example: Some of the examples of such perquisite which are included in the salary income of a specified employee as defined above are:

a. Free boarding facility provided by employer.

b. Free conveyance for private use.

c. Free education facility to the family members of employee.

d. Holiday trips at employer's cost.

e. Gas, electricity or water supplied free for household consumption.

f. Wages of domestic servants paid by employer.

g. Free lunches or dinners.

Caution From 1.4.1990 the use of any vehicle provided by a company or an employer for journey by the assessee from his residence to his office or other place of work, or from such office or place to his residence, shall not be regarded as a benefit or amenity granted or provided to him free of cost or at concessional rate for the purpose of computation of perquisite.

Self Assessment

State whether the following statements are true or false:

17. Medical facility provided to an employee or his family member in any hospitals, clinics, etc. maintained by the employer are not included in salary of a person for taxation of perquisites.

18. Free meals provided by the employer during working hours in a remote area or an offshore installation shall be fully exempt.

19. The value of recreational facilities provided is not exempt.

20. Telephone facility provided at the residence of the employee is exempt to the extent of the amount of telephone bills paid by the employer when it is used for official and personal purposes of the employee.

7.6 Valuation of Perquisites

The perquisites which are taxable in the hands of employees are valued in accordance with the provisions laid down under the Income Tax Rule 3. These benefits can be provided to the employee or member of his household.

Notes

Thus, the basic principles governing valuation of perquisites are as follows:

1. The valuation is done on the basis of their value to the employee and not the employer's cost for providing the same.
2. The value of perquisite is included in the salary income only if the perquisite is actually provided to the employee.
3. Perquisite which is not actually enjoyed by the employee (though the terms of employment provide for the same) cannot be valued and taxed in the employee's hands. Therefore, where the employee waives his right of perquisite, he cannot be taxed thereon.

The valuation of various perquisites is done as follows:

1. ***Valuation of the Perquisite of Rent Free Accommodation:*** For purpose of valuation of the perquisite of unfurnished accommodation, all employees are divided into two categories:

    a) Central Govt. & State Government employees, and

    b) Others.

    For employees of the Central and State governments the value of perquisite shall be equal to the licence fee charged for such accommodation as reduced by the rent actually paid by the employee.

Example: Mr. X, a Senior Officer in Delhi administration draws ₹ 20,000 per month as basic salary. The government has provided him with a rent free unfurnished flat whose market rent is ₹ 3,000 per month, though as per government rules, its licence fees is fixed at ₹ 700 per month. Determine the value of perquisite in respect of rent free accommodation.

Solution:

In a case of government employee, the value of rent free accommodation is ₹ 8,400 (₹ 700 × 12) i.e. the licence fees fixed by the government.

For all others, i.e., those salaried taxpayers not in employment of the Central government and the State government, the valuation of perquisite in respect of accommodation would be at prescribed rates, as discussed below:

(a) Where the accommodation provided to the employee is owned by the employer, the rate is 15% of 'salary' in cities having population exceeding 25 lakh as per the 2001 census.

(b) The rate is 10% of salary in cities having population exceeding 10 lakhs but not exceeding 25 lakhs as per 2001 Census.

(c) For other places, the perquisite value would be 7.5% of the salary.

Where the accommodation so provided is taken on lease or rent by the employer, the prescribed rate is 15% of the salary or the actual amount of lease rental payable by the employer, whichever is lower, as reduced by any amount of rent paid by the employee.

For furnished accommodation, the value of perquisite as determined by the above method shall be increased by:

(a) 10% of the cost of furniture, appliances and equipment, or

(b) where the furniture, appliances and equipment have been taken on hire, by the amount of actual hire charges payable as reduced by any charges paid by the employee himself.

Did u know? Accommodation includes a house, flat, farm house, hotel accommodation, motel, service apartment, guest house, a caravan, mobile home, ship, etc.

The value of any accommodation provided to an employee working at a mining site or an on-shore oil exploration site or a project execution site or a dam site or a power generation site or an off-shore site will not be treated as a perquisite.

However, such accommodation should either be located in a "remote area" or where it is not located in a "remote area"; the accommodation should be of a temporary nature having plinth area of not more than 800 square feet and should not be located within 8 kilometres of the local limits of any municipality or cantonment board. A project execution site for the purposes of this sub-rule means a site of project up to the stage of its commissioning.

Notes A "remote area" means an area located at least 40 kilometres away from a town having a population not exceeding 20,000 as per the latest published all-India census.

If an accommodation is provided by an employer in a hotel the value of the benefit in such a case shall be 24% of the annual salary or the actual charges paid or payable to such hotel, whichever is lower, for the period during which such accommodation is provided as reduced by any rent actually paid or payable by the employee. However, where in cases the employee is provided such accommodation for a period not exceeding in aggregate fifteen days on transfer from one place to another, no perquisite value for such accommodation provided in a hotel shall be charged.

It may be clarified that while services provided as an integral part of the accommodation, need not be valued separately as perquisite, any other services over and above that for which the employer makes payment or reimburses the employee shall be valued as a perquisite as per the residual clause. In other words, composite tariff for accommodation will be valued as per these Rules and any other charges for other facilities provided by the hotel will be separately valued under the residual clause.

Also, if on account of an employee's transfer from one place to another, the employee is provided with accommodation at the new place of posting while retaining the accommodation at the other place, the value of perquisite shall be determined with reference to only one such accommodation which has the lower value as per the table prescribed in Rule 3 of the Income Tax Rules, for a period up to 90 days. However, after that the value of perquisite shall be charged for both accommodations as prescribed.

2. ***Valuation of Motor Car as a Perquisite:*** The valuation of perquisite in respect of motor car provided to the employee shall be calculated in different situations in different ways such as car may be used by the employee wholly for business use or used partly for personal use or partly for business use.

Notes

Table 7.1: Valuation of Motor Car

S. No.	Circumstances	Engine Capacity upto 1600 cc	Engine Capacity above 1600 cc
1	Where the motor car is owned or hired by the employer		
1 (a)	The motor car used wholly and exclusively in the performance of his official. duties;	Nil	Nil
1 (b)	The motor car is used exclusively for the private or personal purposes of the employee or any member of his household and the running and maintenance expenses are met or reimbursed by the employer.	Actual amount of expenditure incurred by the employer on the running and maintenance of motor car including remuneration paid by the employer to the chauffeur and increased by the amount representing normal wear and tear of the motor car less any amount charged from the employee for such use.	
1 (c)	The motor car is used partly in the performance of duties and partly for private or personal purposes of the employee or any member of his household and		
	(i) the expenses on maintenance and running are met or reimbursed by the employer	₹ 1,800 (plus ₹ 900, if chauffeur is also provided to run the motor car)	₹ 2,400 (plus ₹ 900, if chauffeur is also provided to run the motor car)
	(ii) the expenses on running and maintenance for such private or personal use are fully met by the assessee.	₹ 600 (plus ₹ 900, if chauffeur is also provided by the employer to run the motor car)	₹ 900 (plus ₹ 900, if chauffeur is also provided to run the motor car)
2	Where the employee owns the vehicle and the actual running and maintenance charges including remuneration of the chauffeur are met or reimbursed to him by the employer		
2 (i)	The reimbursement is for the use of the vehicle wholly and exclusively for official purposes	Nil Provided that the documents specified in clause (B) of this sub-rule are maintained by the employer.	Nil Provided that the documents specified in clause (B) of this sub-rule are maintained by the employer.
2 (ii)	The reimbursement is for the use of the vehicle partly for official purposes and partly for personal or private purposes of the employee or any member of his household.	Subject to the provisions of clause (B) of this sub-rule, actual expenditure incurred by the employer as reduced by the amount specified in Sl. No.(1)(c)(i) above.	Subject to the provisions of clause (B) of this sub-rule, actual expenditure incurred by the employer as reduced by the amount specified in Sl. No.(1)(c)(i) above.
3	Where the employee owns any other automotive conveyance but the actual running and maintenance charges are met or reimbursed to him by the employer		
	such reimbursement is for the use of the vehicle wholly and exclusively for official purposes;	Nil Provided that the documents specified in clause (B) of this sub-rule are maintained by the employer.	Not Applicable

Contd...

	such reimbursement is for the use of vehicle partly for official purposes and partly for personal or private purposes of the employee.	Subject to the provisions of clause (B) of this sub-rule, the actual amount of expenditure incurred by the employer as reduced by the amount of ₹ 900.	Not Applicable

Source: http://finotax.com/itax/itinfo3.htm

Provided that where one or more motor-cars are owned or hired by the employer and the employee or any member of his household are allowed the use of such motor-cars (otherwise than wholly and exclusively in the performance of his duties), the value of perquisite shall be the amount calculated in respect of one car in accordance with Sl. No. (1)(c)(i) of the above Table as if the employee had been provided one motor-car for use partly in the performance of his duties and partly for his private or personal purposes and the amount calculated in respect of the other car or cars in accordance with Sl. No. (1)(b) of above Table as if he had been provided with such car or cars exclusively for his private or personal purposes.

Where the employer or the employee claims that the motor-car is used wholly and exclusively in the performance of official duty or that the actual expenses on the running and maintenance of the motor-car owned by the employee for official purposes is more than the amounts deductible in Sl. No. 2(ii) or 3(iii) of above Table, he may claim a higher amount attributable to such official use and the value of perquisite in such a case shall be the actual amount of charges met or reimbursed by the employer as reduced by such higher amount attributable to official use of the vehicle provided that the following conditions are fulfilled:-

(a) the employer has maintained complete details of journey undertaken for official purpose which may include date of journey, destination, mileage, and the amount of expenditure incurred thereon;

(b) the employer gives a certificate to the effect that the expenditure was incurred wholly and exclusively for the performance of official duties.

Notes For the purposes of valuation, the normal wear and tear of a motor-car shall be taken at 10% per annum of the actual cost of the motor-car or cars.

3. ***Sweeper, Gardener, Watchman or a Personal Attendant:*** The value of benefit to the employee or any member of his household resulting from the provision of the employer of services or a sweeper, a gardener, a watchman or personal attendant, shall be the actual cost to the employer. The actual cost in such a case shall be the total amount of salary paid or payable by the employer or any other person on his behalf for such services as reduced by any amount paid by the employee for such services.

4. ***Gas, Electric Energy or Water:*** The value of benefit to the employee resulting from the supply of gas, electric energy or water for his household consumption shall be determined as the sum equal to the amount paid on that account by the employer to the agency supplying the gas, electric energy or water. Where such supply is made from the sources owned by the employer, without purchasing them from any other outside agency, the value of perquisites would be the manufacturing cost per unit incurred by the employer. Where the employee is paying any amount in respect of such services, the amount so paid shall be deducted from the value so arrived at.

Notes

5. *Free or Concessional Education:* The value of benefit to the employee resulting from the provision of free or concessional educational facilities for any member of his household shall be determined as the sum equal to the amount of expenditure incurred by the employer in that behalf of where the educational institution is itself maintained and owned by the employer or where free educational facilities for such member of employees' household are allowed in any other educational institution by reason of his being in employment of that employer, the value of the perquisite to the employee shall be determined with reference to the cost of such education in similar institution in or near the locality.

   Where any amount is paid or recovered from the employee on that account, the value of benefit shall be reduced by the amount so paid or recovered. Provided that where the educational institution itself is maintained and owned by the employer and free educational facilities are provided to the children of the employee or where such free educational facilities are provided in any institution by reason of his being in employment of that employer, nothing contained in this sub-rule shall apply if the cost of such education or the value of such benefit per child does not exceed ₹ 1,000 p.m.

6. *Free Food and Non-alcoholic Beverages:* The value of free food and non-alcoholic beverages provided by the employer to an employee shall be the amount of expenditure incurred by such employer. The amount so determined shall be reduced by the amount, if any, paid or recovered from the employee for such benefit or amenity:

   Provided that nothing contained in this clause shall apply to free food and non-alcoholic beverages provided by such employer during working hours at office or business premises or through paid vouchers which are not transferable and usable only at eating joints, to the extent the value thereof either case does not exceed fifty rupees per meal or to tea or snacks provided during working hours or to free food and non-alcoholic beverages during working hours provided in a remote area or an off-shore installation.

7. *Any Gift or Voucher or Token:* The value of any gift, or voucher, or token in lieu of which such gift may be received by the employee or by member of his household on ceremonial occasions or otherwise from the employer shall be determined as the sum equal to the amount of such gift: Provided that where the value of such gift, voucher or token, as the case may be, is below five thousand rupees in the aggregate during the previous year, the value of perquisite shall be taken as nil.

8. *Membership Fees, Annual Fees for Credit Card:* The amount of expenses including membership fees and annual fees incurred by the employee or any member of his household, which is charged to a credit card (including any add-on-card) provided by the employer, or otherwise, paid for or reimbursed by such employer shall be taken to be the value of perquisite chargeable to tax as reduced by the amount, if any paid or recovered from the employee for such benefit or amenity:

   Provided that there shall be no value of such benefit where expenses are incurred wholly and exclusively for official purposes and the following conditions are fulfilled: complete details in respect of such expenditure are maintained by the employer which may, inter alia, include the date of expenditure and the nature of expenditure; the employer gives a certificate for such expenditure to the effect that the same was incurred wholly and exclusively for the performance of official duties.

9. *Membership of Clubs:* The value of benefit to the employee resulting from the payment or reimbursement by the employer of any expenditure incurred (including the amount of annual or periodical fee) in a club by him or by an member of his household shall be determined to be the actual amount of expenditure incurred or reimbursed by such employer on that account. The amount so determined shall be reduced by the amount, if any paid or recovered from the employee for such benefit or amenity:

Provided that where the employer has obtained corporate membership of the club and the facility is enjoyed by the employee or any member of his household, the value of perquisite shall not include the initial fee paid for acquiring such corporate membership.

Nothing contained in this clause shall apply if such expenditure is incurred wholly and exclusively for business purposes and the following conditions are fulfilled – complete details in respect of such expenditure are maintained by the employer which may, inter alia, include the date of expenditure, the nature of expenditure and its business expediency; the employer gives a certificate for such expenditure to the effect that the same was incurred wholly and exclusively for the performance of official duties. Nothing contained in this clause shall apply for use of health club, sports and similar facilities provided uniformly to all employees by the employer.

10. ***Other Fringe Benefits or Amenities:*** In terms of provisions contained in sub-clause (vi) of Sub-section (2) of Section 17, the following other fringe benefits or amenities are hereby prescribed and the value thereof shall be determined in the manner provided thereunder:

(a) *Interest free or concessional loan:* The value of the benefit to the assessee resulting from the provision of interest-free or concessional loan made available to the employee or any member of his household during the relevant previous year by the employer or any person on his behalf shall be determined as the sum equal to the simple interest computed at the rate charged by the State Bank of India in respect of loans for house and conveyance and at the rate charged by the State Bank of India for other loans on the maximum outstanding monthly balance as reduced by the interest, if any, actually paid by him or any such member of his household.

However, no value would be charged if such loans are made available for medical treatment in respect of diseases specified in rule 3A of these rules or where the amount of loans are petty not exceeding in the aggregate ₹ 20,000.

Provided that where the benefit relates to the loans made available for medical treatment referred to above the exemption so provided shall not apply to so much of the loan as has been reimbursed to the employee under any medical insurance scheme.

(b) *Use of any movable asset:* The value of benefit to the employee resulting from the use by the employee or any member of his household of any movable asset (other than assets already specified in this rule and other than laptops and computers) belonging to the employer or hired by him shall be determined @ 10% p.a. of the actual cost of such asset or the amount of rent or charge paid or payable by the employer, as the case may be, as reduced by the amount, if any, paid or recovered from the employee for such use.

(c) *Transfer of any movable asset:* The value of benefit to the employee arising from the transfer of any movable asset belonging to the employer directly or indirectly to the employee or any member of his household shall be determined to the amount representing the actual cost of such asset to the employer as reduced by the cost of normal wear and tear calculated at the rate of 10% of such cost for each completed year during which such asset was put to use by the employer and as further reduced by the amount, if any, paid or recovered from the employee being the consideration for such transfer.

Provided that in the case of computers and electronic items, the normal wear and tear would be calculated at the rate of 50% and in the case of motor cars at the rate of 20% by the reducing balance method (WDV).

Notes Meaning of certain terms mentioned in rules for valuation of perquisites:

1. "Accommodation" includes a house, flat, farm house or part thereof, or accommodation in a hotel, model, service apartment, guest house, caravan, mobile home, ship or other floating structure;
2. "Entertainment" includes hospitality of any kind and also expenditure on business gifts other than free samples of the employer own product with the aim of advertising to the general public;
3. "Hotel" includes licensed accommodation in the nature of motel, service apartment or guest house;
4. "Member of household" shall include:
   - spouse
   - children and their spouses
   - parents
   - servants and dependents
5. "Remote area", for the purposes of proviso to this sub-rule means an area that is located at least 40 kilometres away from a town having a population not exceeding 20,000 based on latest published all India census;
6. "Salary" includes the pay, allowances, bonus or commission payable monthly or otherwise or any monetary payment, by whatever name called from one or more employers, as the case may be but does not include the following, namely:
   - dearness allowance or dearness pay unless it enters into the computation of superannuation or retirement benefits of the employee concerned;
   - employer's contribution to the provident fund account of the employee;
   - allowances which are exempted from payment of tax;
   - the value of perquisites specified in clause (2) of section 17 of the Income-tax Act;
   - any payment or expenditure specifically excluded under proviso to sub-clause (iii) of clause (2) or proviso to clause (2) of section 17;
7. "Maximum outstanding monthly balance" means the aggregate outstanding balance for each loan as on the last day of each month.

Self Assessment

State whether the following statements are true or false:

21. Perquisite which is not actually enjoyed by the employee cannot be valued and taxed in the employee's hands.
22. For purpose of valuation of the perquisite of unfurnished accommodation, all employees are divided into five categories.
23. For employees of the Central and State governments the value of perquisite shall be equal to the licence fee charged for such accommodation as reduced by the rent actually paid by the employee.

24. A "remote area" means an area located at least 80 kilometres away from a town having a population not exceeding 20,000 as per the latest published all-India census.

7.7 Profits in Lieu of or in Addition to Salary

Under this the following items are included:

1. The amount of any compensation due to or received by an assessee from the employer or former employer at or in connection with the termination of his employment.

> *Notes* The 'termination of employment' means retirement, premature termination of employment, termination by death or voluntary resignation.

Generally, under the Income tax Act, the income that is chargeable to tax is only a receipt which is revenue in nature; receipts of a capital nature are not chargeable to tax but this provision constitutes an exception to this rule because compensation received by an employee for termination of his employment would be a capital receipt since it is received in replacement of the sources of income itself. Still it is chargeable to tax because of the specific provision in the Act.

However, relief under Section 89(1) would be available to the assessee in cases where he gets money which represents a profit in lieu of salary; the amount of any compensation due to or received by any assessee from his employer in connection with the modification of the terms and conditions relating to employment.

Example: Where an employer wants to cut down the salary payable to the employee, the lump sum paid to compensate the employee shall be treated as profits in lieu of salary.

In the same way, where the remuneration for services is paid at the end of the period of employment or a lump sum remuneration is paid at the beginning of employment for a number of years, such payment shall be treated as profits in lieu of salary.

2. Any amount due to or received, whether in lump sum or otherwise, by any assessee from any person - (A) before his joining any employment with that person; or (B) after cessation of his employment with that person.

3. Any payment other than the following payment due to or received by assessee from an employer or a former employer or from a provident or other fund, to the extent to which it does not consist of contribution by the assessee or interest on such contributions by the assessee or interest on such contributions or any sum under Keyman Insurance Policy.

7.7.1 Gratuity

'Gratuity' is a retirement benefit. Gratuity Act, 1972 act envisages in providing retirement benefit to the workman who have rendered long and unblemished service to the employer. Gratuity is a reward for long and meritorious service. Earlier, it was not compulsory for an employer to reward his employee at the time of his retirement or resignation. But in 1972 the government passed the Payment of Gratuity Act that made it mandatory for all employers with more than 10 employees to pay gratuity.

Applicability of the Act: The act provides for the payment of gratuity to workers employed in every factory, mine, oil field, plantation, port, railways, shop & Establishments or educational institution employing 10 or more persons on any day of the proceeding 12 months. A shop or establishment to which the Act has become applicable shall continue to be governed by the Act even if the numbers of persons employed falls below 10 at any subsequent stage. Here employees are defined as those hired on the company's payroll. Trainees and interns are not eligible for this compensation.

Eligibility Criteria: Gratuity shall be payable to an "employee" on the termination of his employment after he has rendered continuous service for not less than five years.

1. On his superannuation.
2. On his retirement or resignation.
3. On his death or disablement due to accident or disease.

Fully Exempted Gratuity

The amount of any death-cum-retirement gratuity received under:

a. the revised pension rules of the Central Government; or
b. the Central Civil Services (Pension) Rules, 1972; or
c. any similar scheme applicable to (a), the members of civil services of the Union, or (b) holders of posts connected with defence or of civil posts under the Union, or (c) the member of All India Services, or (d) the members of civil services of a State, or (e) holders of civil posts under a State, or (f) employees of a local authority, or (g) Pension Code or Regulations applicable to the members of the defence services is wholly exempt from tax under Section 10(10)(i) of the Act.

The payment of gratuity by the Life Insurance Corporation of India under the Staff Regulations is wholly exempt from tax under Section 10(10), as the object and purpose of the gratuity scheme of the Life Insurance Corporation of India and the Revised Pension Rules of the Central Government are the same.

Example: Mr. A, an employee of the Central Government, receives ₹ 1,00,000 as gratuity at the time of his retirement on May 1, 2012 under the new pension code. Determine the taxability of the gratuity in his hands for the assessment year 2013-14. In case he joins a private sector company on July 1, 2012 as its Managing Director, will it make any difference?

Solution:

Gratuity received by Mr. A shall be fully exempt from tax under Section 10(10)(i) of the Income-tax Act, 1961 as he is an employee of Central Government. Even if he joins a private sector company after the retirement, the aforesaid exemption shall still be available to him.

Conditions based Exemption

1. ***Where the employees are covered under the Payment of Gratuity Act, 1972:*** The amount of any gratuity received under The Payment of Gratuity Act, 1972, it shall be exempt from tax to the extent of least of the following:

   (a) fifteen days' wages (seven days' wages in case of seasonal establishments) for each completed year of service or part thereof in excess of six months on the basis of salary last drawn for every completed year of service or part thereof in excess of six months; or

   (b) the gratuity actually received; or (c) ₹ 10,00,000 (limit raised by notification no.43/ 2010 dt.11-06-2010)

Notes "Wages" means all emoluments which are earned by an employee while on duty or on leave in accordance with the terms and conditions of his employment and which are paid or are payable to him in cash and include dearness allowance but do not include any bonus, commission, house rent allowance, overtime wages and any other allowance.

The Supreme Court has held that wages of fifteen days or seven days, as the case may be, will be calculated by dividing the wages last drawn by 26, i.e. maximum number of working days in a month.

Example: Mr. B is employed in a non-seasonal factory at a salary of ₹ 2,400 P.M. Besides, he also gets dearness allowance @ 600 P.M. and bonus @ ₹ 200 P.M. He retires on December 31, 2012 and gets 75,000 as gratuity under the Payment of Gratuity Act after serving 31 years and 4 months in that factory. Compute the amount of gratuity which is exempt under the Income-tax Act, 1961.

Solution:

In this case 31 years shall be taken as completed years of service. 15 days' salary is ₹ 1,730.77 (i.e. ₹ 3,000 × 15 ÷ 26) Out of ₹ 75,000 received as gratuity, the least of the following will be exempt from tax:

(i) 53,654 (being 15 days salary for each completed year of service i.e. ₹ 1,730.77 × 31);

(ii) 10,00,000; or

(iii) 75,000 (being gratuity actually received).

Hence, ₹ 53,654 being the least is exempt from tax and the balance ₹ 21,346 is taxable for the assessment year 2013–14.

2. ***Where the employees are not covered under the Payment of Gratuity Act, 1972:*** The amount of any other gratuity received by the employee from a private employer on his retirement or at the termination of his employment or on his becoming incapacitated or received by the employee's nominee on the former's death, to the extent it does not, in either case,

    (a) exceed one–half month's salary for each year of completed service, calculated on the basis of the average salary for the ten months immediately preceding the month in which any such event occurs or

    (b) ten lakhs rupees or

    (c) gratuity actually received Where gratuities are received by the employee from more than one employer in the same previous year, the aggregate amount exempt from income-tax under (c) shall not exceed 10,00,000.

Notes Where any gratuity/gratuities was/were received in any one or more earlier previous years also and the whole or any part of the amount of such gratuity was not included in the total income of the assessee, the limit of ₹ 10, 00,000 will be reduced by the amount of gratuity which has been exempted earlier.

'Salary' includes dearness allowance, if the terms of employment so provide, but excludes all other allowances and perquisites. Where an employee receives dearness pay, it shall be included in the salary.

The Supreme Court has held that if under the terms of employment, commission is payable at a fixed percentage of turnover achieved by the employee such commission would partake of the character of 'Salary'. Therefore, salary will be basic salary, dearness allowance (forming part of salary for retirement benefits) and percentage commission.

"Year" means the calendar year commencing from the 1st of January and ending on the 31st December. "Each year of completed service" means a period of twelve months' service rendered by the employee, reckoned from the date on which he joined service with his employer.

Example: Mr. C, who is not covered by the Payment of Gratuity Act, received a gratuity of ₹ 90,000 on retirement on December 31, 2012 after serving 35 years (forms part of salary for retirement benefits) and 8 months. His last drawn emoluments were: Basic salary ₹ 4,000 p.m. Dearness allowance ₹ 1,000 p.m. Annual increment of ₹ 200 p.m. falls due on 1st October each year. Determine the amount of gratuity exempt from tax for the assessment year 2013–14.

Solution:

In this case 35 years shall be taken as completed years of service. Average salary shall be computed as under:

Basic salary and D.A. drawn by him during:

(i)	February 1, 2012 to September 30, 2012 @ ₹ 4,800	
	(i.e. ₹ 3,800 + 1,000) × 8 months	= 38,400
(ii)	October 1, 2012 to November 30, 2012 @ ₹ 5,000	
	(i.e. ₹ 4,000 + 1,000) × 2 months	= 10,000
	Total salary for 10 months 48,400	
	Average salary p.m. = ₹ 48,400 ÷ 10	= 4,840
	Hence 1/2 month's average salary	= 4,840 ÷ 2
		= 2,420 p.m.

Out of 90,000 received as gratuity, the least of the following will be exempt from tax.

(i) 84,700 (being 1/2 month's salary for each completed year of service i.e. 2,420 × 35);

(ii) 10,00,000; or

(iii) 90,000 (being gratuity actually received).

Hence, 84,700 being the least is exempt from tax and is not taxable for the assessment year 2013–14.

7.7.2 Commuted Value of Pension

(a) In case of Government employees (Central, State, Local authority or statutory corporation), the full amount of commuted value of pension is exempted.

(b) In case of non-Government employees, the exemption is as follows:

  (i) where the employee receives any gratuity, the commuted value of one-third of the pension which he is normally entitled to receive;

  (ii) where the employee does not receive any gratuity, the commuted value of one-half of such pension.

Example: Mr. A is entitled to get a pension of ₹ 600 per month from a private company. He gets three-fifth of the pension commuted and receives ₹ 36,000. Compute the taxable portion of commuted value when:

(a) he receives ₹ 20,000 as gratuity

(b) he does not receive gratuity.

Solution:

Commuted value of 3/5 of pension 36,000

Commuted value of full pension i.e. $5/3 \times 36{,}000 = 60{,}000$

(a) If Mr. A receives gratuity:

Amount exempt shall be one third of commuted value of full pension = $1/3 \div 60{,}000 = 20{,}000$

Commuted pension chargeable to tax as salary = (36,000 – 20,000) = 16,000

(b) If Mr. A does not receive gratuity:

Amount exempt shall be one half of commuted value of full pension = $1/2 \div 60{,}000 = 30{,}000$

Commuted pension chargeable to tax as salary= (36,000 – 30,000) = 6,000

7.7.3 Encashment of Earned Leave

Clause 10AA of Section 10 grants the following exemptions on this account:

1. Any payment received by an employee of the Central Government or a State Government as the cash equivalent of leave salary in respect of the period of earned leave at the employee's credit only at the time of retirement whether such retirement is on superannuation or otherwise. The effect of this clause is that payments received by an employee in respect of any period of leave not availed by him would be chargeable to tax except, when such payments are made at retirement and qualify for exemption under Section 10(10AA) of the Act.

2. Any payment as encashment of earned leave received from any other employer is exempt to the extent of: For non-government employees (including employees of local authority or statutory corporation), least of the following:

   (a) Cash equivalent of the leave salary in respect of the period of earned leave standing to the credit of employee at the time of retirement/superannuation (maximum earned leave entitlement being: 30 days for every year of actual service rendered for the employer from whose service he has retired); or

   (b) 10 month's "average salary", i.e. salary drawn during the period of 10 months immediately preceding the retirement/superannuation, or ["Salary in this context, means, Basic salary and includes dearness allowance if terms of employment so provide. It also includes commission based on fixed percentage of turnover achieved by an employee as per terms of contract of employment.

   (c) The amount specified by the Government. The maximum amount which is not chargeable to tax under Section 10(10AA)(ii) of the Act, as specified by the Government is given below:

(d) The amount of leave actually received at the time of retirement.

Date of Retirement (Whether superannuation or otherwise)	Amount
Between January 1, 1988 and March 31, 1995	79,920
Between April 1, 1995 and June 30, 1995	1,30,320
Between July 1, 1995 and July 1, 1997	1,35,360
Between July 2, 1997 and April 1, 1998	2,40,000
After April 1, 1998	3,00,000

Example: Mr. P, an employee of a company, receives 7, 75,000 as leave salary at the time of his retirement on December 31, 2012. Determine the amount of taxable leave salary for the assessment year 2013–14 from the following information:

Salary at the time of retirement	25,000
Average salary received during last 10 months:	
From March 1, 2012 to September 30, 2012	24,000
From October 1, 2012 to December 31, 2012	25,000
Duration of Service	26 years
Leave entitlement for each year of service	1½ months
Leave availed while in service	8 months
Leave at the credit of employee at the time of retirement (26 × 1.5 – 8)	31 months
Leave salary paid at the time of retirement (i.e. ₹ 25,000 x 31)	7, 75,000

Solution:

The amount of exemption under Section 10(10AA) of the Act shall be computed as under:

Leave entitlement @ one month leave for every year of service	26 months
Leave availed while in service	8 months
Leave standing to the credit of the employee at the time of retirement	18 months
Average salary of last 10 months ending on December 31, 2012 [i.e. (₹ 24,000 x 7 + ₹ 25,000 x 3) ÷ 10]	24,300

Out of 7, 75,000 received as encashment of leave, the least of the following will be exempt from tax:

(i)	Cash equivalent of leave to the credit of Mr. P at the time of retirement (i.e. 24,300 × 18)	4,37,400
(ii)	10 month's average salary (i.e. 24,300 x 10)	2,43,000
(iii)	Amount specified by the Government	3,00,000
(iv)	Amount received from the employer	7,75,000

Notes

Hence, 2, 43,000, being the least, shall be exempt from tax under Section 10(10AA) of the Act and the balance 5,32,000 (i.e. 7,75,000 - 2,43,000) shall be taxable for the assessment year 2013–14.

Retrenchment Compensation

Retrenchment compensation received by a workman under the Industrial Disputes Act, 1947 or any other Act or rules, orders or notifications issued thereunder or under any standing orders or under any award, contract of service or otherwise to the extent of the actual award or ₹ 5,00,000 the amount notified by the Central Government or the amount calculated u/s 25F(b) of the Industrial Disputes Act, 1947 whichever is less.

Amount received from Statutory Provident Fund and/or Public Provident Fund or Recognised Provident Fund

The amount is exempt if the following conditions are satisfied:

1. he has rendered a continuous service with his employer for five years or more; or
2. if he has not rendered such continuous service, the service has been terminated by reason of his ill health, or discontinuance or contraction of employer's business or any other cause beyond the control of employee; or
3. on cessation of his employment, he obtains employment with any other employer and balance standing in his Recognised Provident Fund is transferred to his account in the Recognised Provident Fund maintained by the new employer.

Caution Where the accumulated balance of recognised provident fund has been transferred to any other Recognised Provident Fund [under clause (iii)] then in computing the period of continuous service for clause (i) or clause (ii), the period or periods for which the employee rendered continuous service under his former employer or employers shall be included.

Self Assessment

Fill in the blanks:

25. ……………………………means retirement, premature termination of employment, termination by death or voluntary resignation.
26. ……………………….. is a reward for long and meritorious service.
27. ………………………………envisages in providing retirement benefit to the workman who have rendered long and unblemished service to the employer.
28. …………………………………… received by a workman under the Industrial Disputes Act, 1947.

7.8 Deductions Allowed from Salaries (Section 16)

The following amounts shall be deducted in order to arrive at the chargeable income under the head 'Salaries'.

1. ***Standard deduction:*** Omitted by Financial Act, 2005 w.e.f. 1.4.2006. – Section 16(i)

2. *Entertainment allowance:* Where the employee is in receipt of entertainment allowance, the amount so received shall first be included in the salary income and thereafter the following deduction shall be made - Section 16(ii):

   A deduction in respect of any allowance in the nature of an entertainment allowance specifically granted by an employer to the assessee who is in receipt of a salary from the Government, a sum equal to one-fifth of his salary (exclusive of any allowance, benefit or other perquisite) or five thousand rupees, whichever is less.

   W.e.f. April 1, 2002 entertainment allowance will be allowed in computing income from salary only in case of employees of the Government and will cease to be allowable for persons other than those employed in Government i.e. entertainment allowance deduction will not be allowed to other employees.

Notes For this purpose 'Salary' excludes any allowance, benefit or other perquisites:

Where an employee, not entitled to claim deduction under this clause, spends some money on the entertainment of customers of the concern, the amount so spent cannot be deducted from the salary income. The condition makes exemption well-nigh impossible for the employees of private sector. For them, the better course would be to get the entertainment expenses reimbursed.

3. ***Tax on employment or Professional Tax:*** From the assessment year 1990–91, deduction shall be allowed in respect of any sum paid by the assessee on account of a tax on employment within the meaning of clause (2) of article 276 of the Constitution, leviable by a State under any law passed by its legislature.

Where Professional or Employment tax is paid by the employer on behalf of the employee, it will first be included in his gross salary as a perquisite, being a monetary obligation of the employee discharged by the employer. Thereafter, a deduction on account of such professional tax shall be allowed to the employee from his gross salary. Professional tax due but not paid shall not be allowed as deduction.

Caution Incomes exempt from tax and not includible in 'Salary'

The following items are exempt from tax, subject to the limits applicable for each:

1. Leave Travel Allowance [Section 10(5)];
2. Remuneration of a person who is not a citizen of India [Section 10(6)];
3. Allowances payable outside India [Section 10(7)];
4. Remuneration of an employee working under the Co-operative Technical Assistance Programme [Section 10(8)];
5. Death-cum-retirement gratuity [Section 10(10)];
6. Amount received in commutation of Pension [Section 10(10A)];
7. Encashment of earned leave [Section 10(10AA)];
8. Retrenchment compensation [Section 10(10B)];
9. Payment received from Statutory Provident Fund [Section 10(11)];
10. Payment received from a recognised Provident Fund [Section 10(12)];

Notes

11. Payment received out of an approved Superannuation Fund [Section 10(13)];
12. House rent allowance [Section 10(13A)];
13. Special allowances to meet the expenses of the duties [Section 10(14)];
14. Salary income of a member of Scheduled Tribe [Section 10(26)];
15. Salary income of a resident of Ladakh [Section 10(26A)].

Notes **Tax Deducted at Source**

Salaries payable by an employer are chargeable to tax in the hands of the employee and are subject to deduction of tax at source under Section 192 of the Income-tax Act. The obligation of the employer to deduct tax at source is mandatory and cannot be negotiated. But in cases where there is any failure on the part of the employer to deduct the tax at source, the employee cannot escape liability to tax; he would be chargeable to tax on his entire income from salaries. The fact that the employer could be proceeded against and be subjected to penalty or prosecution, would not absolve the employee of his liability to pay tax on the income which should have been subjected to deduction of tax by the employer. In every case, the tax deducted by the employer should be added to the employee's income and the gross amount should be taken as the taxable income of the employee.

Important examples of computation of Income from Salary are given below:

Example: Calculation of taxable house rent allowance:

Mr. Ram is employed at Bombay. His basic Salary is ₹ 5,000 per month. He receives ₹ 5,000 p.a. as house rent allowance. Rent paid by him is ₹ 12,000 p.a. Find out the amount of taxable house rent allowance.

Solution:

As per Rule 2A, the least of the following is exempt from tax:

1. the actual house rent allowance;
2. excess of rent paid over 10% of salary;
3. where the accommodation is situate at Bombay, Delhi, Calcutta or Madras, one-half of the amount of salary due to the assessee for the relevant period;
4. Where the accommodation is situating at any other place, two-fifth of the salary due to the assessee for the relevant period.

Accordingly, Mr. Ram would be entitled to the least of:

(i) 5,000 or

(ii) 6,000 being excess of rent over 1/10th of salary; or

(iii) 30,000 (being one-half of the salary of the assessee).

5,000, being the least, would not be included in the total income of Mr. Ram. So the entire amount of HRA would be exempt from tax.

Salary for this purpose includes basic salary as well as dearness allowance if the terms of employment so provide. It also includes commission based on a fixed percentage of turnover achieved by an employee as per terms of contract of employment but excludes all other allowances and perquisites and these are determined on due basis for the period during which rental accommodation is occupied by the employee in the previous year.

Example: Valuation of rent free unfurnished accommodation: Mr. Shyam, employed at Mumbai, receives the following from his employer during the previous year:

Basic Salary	60,000
Bonus	1,800
Entertainment allowance (taxable)	6,000
Electricity expenses	2,000
Professional tax paid by the employer	2,000
Rent free house (owned by Employer):	
Fair rent	48,000
Salary of gardener	2,400
Garden Maintenance	1,200
Salary of watchman	1,800

Determine the value of taxable perquisites in respect of rent free house assuming (a) Mr. Shyam is a Government Officer and the fair rent as arrived at by the Government is ₹ 6,000 p.a (b) Mr. Shyam is a semi-Government employee, and (c) Mr. Shyam is employed by a private company.

Solutions:

(a) If Mr. Shyam is a Government Officer: As per Rule 3(1) of Income-tax Rules, ₹ 6,000 p.a. being the rent of the house as per Government rules, will be the taxable value of the perquisite.

(b) If Mr. Shyam is a semi-Government employee: As per Rule 3(1) of the Income-tax Rules, the value of the perquisite in respect of rent free accommodation is taken at 15% of salary of the employee (as the house is owned by the Employer and provided in Mumbai).

1. Salary = 67,800 (₹ 60,000 + 1,800 + 6,000)
2. 15% of salary = 10,170 and
3. Therefore, ₹ 10,170 is taxable value of the perquisite.
4. Further, the value of Electricity expenses and Professional Tax paid by the employer, being perquisites, are not included in the salary for valuation of Rent Free House Accommodation.

(c) If Mr. Shyam is employed in Private Company: The value of perquisite in this case shall also be 10,170. Under the new rules there is no difference between the semi-Govt. and other employees.

Example: Mr. Ramamoorthy, an employee of M/s. Gopalkrishnan & Co. of Chennai receives during the previous year ended March 31, 2013 the following payments:

Basic Salary	40,000
Dearness allowance	3,000
Leave Salary	5,400

Professional tax paid by employer	1,000
Fair rent of the flat provided by employer	6,000
Rent paid for furniture	1,000
Rent recovered by employer	3,000
Contribution to Statutory Provident Fund	4,000
Employer's contribution to Statutory Provident Fund	4,000

Compute his taxable income for the Assessment Year 2013–14.

Solution:

Computation of taxable income of Mr. Ramamoorty for the Assessment Year 2013–14

Basic Pay		40,000
Dearness allowance		3,000
Leave salary		5,400
Professional tax paid by employer		1,000
Perquisite for House:		
15% of salary (' 40,000 + 3,000 + 5,400)	7,260	
Add: Furniture rent	1,000	
Less: Rent recovered	(–) 3,000	5,260
		54,660
Less: Professional tax u/s 16		1,000
Gross Total Income		53,660
Less: Tax deduction under Section 80C		4,000
Tax on total income		49,660
Total tax payable		NIL

Note: Assumed that dearness allowance forms part of the salary for the purpose of computation of superannuation or retirement benefits.

Example: For the year ended 31.3.2013, B receives a salary of 91,000 and conveyance allowance of 24,000. He is also provided with accommodation at Mumbai at concessional rent. The monthly rent of the accommodation is 7,500 of which 5,000 is paid by the employer. The balance of 2,500 is paid by B. B's contribution to employee's provident fund account is 7,592 and he pays 10,298 as life insurance premia. His expense on conveyance for official purposes was 22,500 for the year. Compute B's tax liability for the assessment year 2013–14 assuming that he has no other income.

Solution:

Basic Salary	91,000	
Conveyance allowance	24,000	
Less: Amount exempt under Section 10(14) (800 × 12)	9,600	14,400

Perquisite value of accommodation provided at concessional rent	Nil
Gross Salary	1, 05,400
Net Income from Salary	1, 05,400
Less: Deduction under Section 80C (7,592 + 10,298)	17,890
Total Income	87,510
Tax liability	Nil

Note: Salary for the purpose of calculation of perquisite value of accommodation provided at concessional rent is 91,000 + 14,400 = 1,05,400. The value of the house perquisites shall be:

15% of salary	15,810
Less: Rent actually paid by B	30,000
Perquisite value	Nil

Example: Mr. A, the General Manager of XYZ Ltd., retired on 31.12.2012 after 30 years of service.

The particulars of his income are as follows:

1. Salary 10,000 per month from January 1,2012. House rent allowance ₹ 4,000 per month from January 1, 2012.
2. Medical expenses reimbursed by employer: ₹ 7,200 for the period from April 1, 2012 to December 31, 2012.
3. Mr. A and his family also availed LTC - they visited Mumbai and the expenses of ₹ 5,600 being the cost of air conditioned second class rail tickets were reimbursed by the employer.
4. The employer provides him a car for personal purposes and expenses are incurred by the employer amounting to ₹ 9,900.
5. Mr. A contributes 22% (12% regular and 10% additional voluntary contribution) to recognised provident fund and the company matches his regular contribution of 12%.
6. Mr. A has invested ₹ 20,000 in ULIP Scheme of UTI and ₹ 10,000 in public provident fund. He paid 8,000 towards life insurance premium on policy for a sum assured of ₹ 60,000.
7. He lives in his own house. The annual municipal value of the house is ₹ 15,000.
8. Payment of club bills to the extent of ₹ 2,700 for the year being monthly subscription @ 300 per month was reimbursed by the employer.
9. Mr. A received 1, 50,000 as gratuity. He is not covered by the Payment of Gratuity Act.
10. He received 1, 60,000 for encashment of leave, being 16 months' leave not availed of.

Compute A's income for the assessment year 2013–14.

Solution:

(a)	Salary (10,000 x 9)	90,000
	HRA (4,000 x 9)	36,000
	Payment of club bills (300 x 9)	2,700
	Gratuity (See note 7)	—

	Car facility	9,900	
	Encashment of leave (1,60,000 – 1,00,000)		
	(See note 8)	60,000	
	Gross salary income	1, 98,600	
	Net salary income	1, 98,600	
(b)	Income from house property (one-self occupied house)		
	[Wholly exempt under Section 23]	NIL	
	Gross Total income	1, 98,600	
	Less: Deduction under Section 80C	—	
	Less:		
	Qualifying Amount (QA) for deduction under Section 80C of the Act:		
	PF contribution	19,800	
	ULIP purchased	20,000	
	Contribution in PPF	10,000	
	Life Insurance premium	8,000	
	Qualifying Amount:		57,800
	Total Income		1, 40,800
	Tax payable		0
	Add: Education cess @ 2%		0
	Tax liability of Mr. A for assessment year 2013–14		0

Notes In context of the above case note the following:

1. HRA is fully taxable as X lives in his own house.
2. Medical expenses reimbursed are not chargeable to tax to the extent of ₹15,000.
3. Reimbursement of rail fare (air conditioned second class) is exempt under Section 10(5) of the Act. Further, it is presumed that other conditions as laid down in Rule 2B of Income-tax Rules, 1962 are also satisfied.
4. Life insurance premium qualifies for deduction under Section 80C.
5. Notional income from one self occupied house is not chargeable to tax. Deduction of municipal taxes, insurance premium etc. in respect of such house is also not allowed.
6. Club bills are taxable unless the membership is primarily for the benefit of the employer. It is presumed in this case that it is not so.
7. Gratuity is exempt to the least of the following:
   (i) ½ month's salary for every completed year of service (calculated on the basis of average salary for 10 months preceding the retirement), 10,000 × ½ × 30 = 1, 50,000.

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(ii) ₹ 10, 00,000.

(iii) Actual gratuity received ₹ 1,50,000.

8. Leave salary is exempt to the extent of the least of the following:

(i) Salary in respect of unavailed leave at the time of retirement 1,60,000

(ii) Salary for 10 months 1,00,000

(iii) Limit of exemption as specified by the Government 3,00,000

(iv) Leave encashment actually received at the time of retirement 1,60,000

Exemption is limited to ₹ 1,00,000 being the least of the amounts mentioned above.

Self Assessment

State whether the following statements are true or false:

29. Standard deduction has been omitted by Financial Act, 2005 w.e.f. 1.4.2006. – Section 16(i).

30. Where the employee is in receipt of entertainment allowance, the amount so received shall first be included in the salary income and thereafter the following deduction shall be made - Section 16(ii).

31. W.e.f. April 1, 2003 entertainment allowance will be allowed in computing income from salary only in case of employees of the Government and will cease to be allowable for persons other than those employed in Government i.e. entertainment allowance deduction will not be allowed to other employees.

32. Where Professional or Employment tax is paid by the employer on behalf of the employee, it will first be included in his gross salary as a perquisite, being a monetary obligation of the employee discharged by the employer.

Case Study

In Case of Expatriate, Seconded to Indian Company, Liability of TDS on 'Home Salary' Paid by the Foreign Company Outside India — Sec. 192

A person responsible for making certain payments [Payer] to a resident or a non-resident (Payee) is required to deduct tax (TDS) as provided in various provisions contained in Chapter XVIIB of the Income-Tax Act, 1961 (the Act). In the last few years, the net of TDS is substantially widened from time to time by the Government and large number of payments is now covered within those provisions. A large portion of direct tax collection is made by the Government through TDS provisions.

Out of the collections made by the Government by way of TDS, a major portion of the collection represents the TDS from salary income. Sec.192(1) provides that any person responsible for paying (Employer) any income chargeable under the head 'Salaries' [hereinafter referred to as Salary Income], at the time of payment, is required to deduct tax on the estimated Salary Income of the assessee (Employee) for relevant financial year as provided in the Section. Such Employee could be resident or non-resident. The only criterion is taxability of Salary Income under the Act. Such tax is required to be deducted at an

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average rate of Income-tax as provided in the Section. Sec.192(2) further provides that if the assessee (Employee) is employed simultaneously under more than one employer during the financial year, etc., he may furnish to the Employer referred to in Sec.192(1) such details of his Salary Income from the other employer or employers in the prescribed form (Form No.12B) and in that event, such Employer is under an obligation to take into account such details for the purpose of making deduction under Sec.192(1). The provisions contained in Sec.192(2) are regarded as optional for the assessee (Employee).

When a non-resident (say, a Foreign Company) makes payment outside India to any resident (or to non-resident in certain cases) falling within any of the provisions contained in Chapter XVIIB, then in such a case, whether such a non-resident also is required to deduct tax or not is a matter which is currently under debate on the ground as to whether such machinery provisions of the Act can be applied beyond the territories of India [i.e., on the ground of extra-territorial jurisdiction]. The Department holds the view that in such an event, even such a non-resident making payment outside India is required to deduct tax and comply with the provisions of the Act with regard to TDS. This view of the Department is also reflected in some of the Circulars issued by the CBDT [e.g., Circular No.726, dated 18.4.1995, under which certain exceptions for TDS are provided for payments made by non-residents to resident Payees, being lawyers, chartered accountants, etc.].

In many cases, a Foreign Company enters into joint venture with an Indian partner in respect of some business activities for which a company is incorporated in India jointly with the resident joint venture partner [J. V. Company or Indian Company]. Similarly, many a time, a Foreign Company incorporates a subsidiary company in India for carrying out certain business activities [Indian Company]. In such cases, many a time, such Foreign Company deputes its employees on secondment basis to such Indian Company and the expatriates so seconded remain in India for a specified period in the employment of the Indian Company (generally such expatriates also become resident in India under the Act during such a period). In such cases, the Indian Company makes payment of salary, etc. and deducts tax under Sec.192(1) in respect of such payments. At the same time, in many such cases, such expatriates seconded by the Foreign Company to the Indian Company retain their lien on their job with the Foreign Company and also continue to remain on the rolls of the Foreign Company, and, apart from the salary, etc. received from the Indian Company, they also receive the agreed remuneration outside India in foreign currency from such Foreign Company (Home Salary). In such cases, no reimbursement is made by the Indian Company in respect of such Home Salary received by the expatriates and the same is also not claimed as deduction in computing the taxable income of the Indian Company. In such cases, the issue with regard to taxability of such Home Salary in India is under debate, which has to be decided on the basis of facts and circumstances of each case. In cases where such Home Salary is related to the services rendered by such expatriates in India, the same is generally treated as taxable income in India and in such an event, further issue with regard to liability of TDS in respect of such Home Salary is also under debate. In many cases, the Department has taken a stand that since such Home Salary relates to services rendered in India, the same is deemed to have accrued or arisen in India under Sec.9(1)(ii) and accordingly, the Indian Company is liable to deduct tax under Sec.192(1), as no work is performed by such expatriates for the Foreign Company during such periods.

Recently, the Apex Court had occasion to consider the issues referred to hereinbefore in the case of Eli Lilly & Co. India Pvt. Ltd. [Civil Appeal No.5114/2007] and other cases. Therefore, the judgment of the Apex Court in this batch of cases is of great importance and hence, it is thought fit to consider the same in this column.

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Eli Lilly & Co. India Pvt. Ltd. and Others —178 Taxmann 505 (SC)

In the above cases (taken up by the Apex Court together), the Home Salary was paid by a Foreign Company to its employees seconded to the Indian Company [which was also not reimbursed by the Indian Companies], no tax was deducted on such payments. The Indian Companies had deducted tax under Sec.192 in respect of Salary Income paid by them to such seconded expatriates. In some cases, the employees had filed their returns of income in India and paid taxes on the Home Salary. In some cases, it seems, initially, a stand was taken that Home Salary is not taxable in India, but it appears that subsequently such stand was given up and taxes were paid. Since a large number of cases were involved, the detailed facts in respect of each one of those cases are not available except for one case to which reference is made hereinafter. Primarily, it seems that in all cases, the Indian Companies were treated as 'assessee-in-default' under Sec.201 and interest was charged under Sec.201(1A) and in some cases, penalty under Sec.271C was also levied for non-deduction of tax. It seems that in all cases, the High Court had decided these issues in favour of the Indian Companies.

In the case of M/s. Eli Lilly & Co. India Pvt. Ltd. (Indian Company), the brief facts were: The Company was engaged in manufacturing and selling pharmaceutical products during the Financial Years 1992–93 to 1999–2000. The Company was a J. V. Company between Messrs. Eli Lilly Inc., Netherlands (Foreign Company) and its Indian Partner, M/s. Ranbaxy Ltd. The Foreign Company had seconded four expatriates to the Indian Company (i.e., J. V. Company) and the appointment was routed through a J. V. Board consisting of Indian Partner and the Foreign Company. Only a part of their aggregate remuneration was paid in India by the Indian Company on which tax was deducted under Sec.192(1). These expatriates, who were seconded by the Foreign Company to the J. V. Company in India, also continued to be on the rolls of the Foreign Company and they received Home Salary outside India in foreign currency from the said Foreign Company, on which no tax was deducted. A survey under Sec.133(A) was carried out and in the course of such survey, these facts were noticed. The post-survey operations revealed that those expatriate who were employed by the Indian Company (on being seconded by the Foreign Company), no work was performed by them for the Foreign Company. Based on these facts, the Assessing Officer (A.O.) found that total remuneration paid to them was only on account of services rendered in India and therefore, the same is taxable in India in terms of Sec.9(1)(ii), and accordingly subject to tax deduction under Sec.192(1) of the Act. It was the contention of the Indian Company that the Home Salary is paid by the Foreign Company to expatriates outside India, de hors the contract of employment in India. The A.O. treated the Indian Company as 'assessee-in-default' under Sec.201 in respect of Home Salary paid by the Foreign Company outside India and levied interest under Sec.201(1A). In the Appellate proceedings, the Tribunal and the High Court took a view that the Indian Company was not under statutory obligation to deduct tax under Sec.192 on the Home Salary paid by the Foreign Company, as it was not paid by the Indian Company and hence it is not an 'assessee-in-default'. At the instance of the Department, the matter came up before the Apex Court and the Apex Court decided to dispose of this case as well as other cases involving similar issues together.

On behalf of the Revenue, it was submitted that Sec.192 comprises the following four elements:

(i) It imposes an obligation of 'deducting' tax on 'any person' responsible for paying any income chargeable under the head 'salary',

(ii) Clarifies that this obligation attaches itself 'at the time of payment', which is the temporal time-frame,

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(iii) The rate is to be determined on the basis of the average rate of Income-tax for the financial year, and

(iv) Most importantly, the rate is to be applied 'on the estimated income of the assessee under this head for that financial year', i.e., for the totality of the assessable salary income of the assessee-employee.

On behalf of the Department, it was, inter alia, further contended that the expression 'any person' in Sec.192 would include any person responsible for making salary payment to an employee, whether such employee is in India or outside India or whether such payment is made in India or outside India. The only requirement is that the assessee employee must be paid in respect of services rendered in India. A reference was also made in Sec.192(2) to draw a distinction between the expressions, 'making the payment' and 'making the deduction'. With this distinction, it was contended that the very fact that Sec.192(2) authorises the employee to choose one of the several persons 'making the payment' and not 'making the deduction' is an indication that the obligation under Sec.192(1) attaches to 'any' person, who is responsible for making payment of Salary Income and is not limited to a person, who is under an obligation to deduct tax at source. It was finally contended that Sec.192 imposes a joint and several obligation on all the persons, who are responsible for paying any Salary Income to employees in India. In the alternative, it was contended that if it is held that it is only Indian Employer who is obliged to deduct tax at source and not the foreign employer (who is directly paying to the foreign account of the employee outside India), the obligation of the Indian employer has to be interpreted co-extensively and in respect of the entire Salary Income of the employees, so long as such Salary Income of the employee arises or accrues in India or is in respect of 'services rendered in India'.

With regard to the issue relating to penalty under Sec.271C, on behalf of the Department it was contended that such penalty is in the nature of civil liability. The burden of bringing the case within the exception provided in Sec.273B, namely, showing 'reasonable cause', is squarely on the assessee. It was pointed out that in these appeals, the assessee has pleaded bona fide misunderstanding of law, which explanation does not satisfy the test of 'reasonable cause' and therefore, merits rejection.

The counsel appearing on behalf of M/s. Eli Lilly & Co. India Pvt. Ltd. [i.e., an Indian Company] raised various contentions. The Indian Company (which is Employer in India) was under no obligation to deduct tax under Sec.192(1) from the Home Salary, which was admittedly not paid by it. Sec.192(1) obliges the Employer to deduct tax out of the estimated salary income at the time of making payment thereof. Such TDS is required on estimated income for the reason that Salary Income is liable to change during the year on account of various reasons, such as increment, pay revision, payment of bonus, D.A., valuation of perquisites in kind, etc. Unlike most of the other provisions, TDS is required under Sec.192(1) at the time of payment of salary, the obligation of Employer is to deduct tax qua the amount actually paid by the Employer or paid on his behalf or on his account. Sec.192(2) specifically provides that when the employee is simultaneously in employment of more than one employer, the employee has an option to file with one employer (the chosen employer), a declaration of salary earned by him in Form No.12B and in that event, such chosen employer is under an obligation to deduct tax on aggregate Salary Income of the employee. In the absence of exercise of option under Sec.192(2), the obligation of each employer is confined to the amount of salary actually paid by him and there is no statutory obligation on one employer to take into account the salary paid by other employer for the purpose of TDS. The TDS provisions are in the nature of machinery provisions, which enable easy collection and recovery of tax and the same are independent of charging provisions which are applicable to the recipients of income, whereas the TDS provisions

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are applicable to the Payer of income. The obligation of TDS on the Payer is independent of assessment of income in the hands of all the expatriate employees and hence the employer is obliged to deduct tax at source only from the payment made by him or payment made on his behalf or on his account. Each employer is required to comply with the TDS obligations in respect of Salary Income paid by him and the obligation does not extend to deduct tax out of Salary Income paid by other persons, when it is not on account of or on behalf of such employer, notwithstanding the fact that such salaries may have nexus with the service of the employee with the employer (Indian Company) and may be assessable to tax in India in the hands of the recipient employee. The payment of Home Salary by the Foreign Company in Netherlands was not on behalf of or on account of the Indian Company and consequently, the Indian Company was not under a statutory obligation to deduct tax from the entire Salary Income of the expatriate including Home Salary, particularly when the expatriates did not exercise an option under Sec.192(2) requiring the Indian Company to deduct tax from their aggregate Salary Income. It was also pointed out that each of the expatriate employees had paid directly the tax due on the Home Salary by way of advance tax/self-assessment tax from time to time and they had also filed their returns of income in India. In view of this, there is no loss to the Revenue of the alleged default of not deducting tax on the entire Salary Income as on account of short deduction of tax and hence, even if the Indian Company is regarded as 'assessee-in-default' in terms of Sec.201 of the Act, the tax alleged to be in default cannot be once again recovered from the Indian Company.

The counsel appearing on behalf of another Indian Company [M/s. Erection Communications Pvt. Ltd.] raised various contentions. These include contentions with regard to the issue that such TDS provisions have no extra-territorial operations. In this regard it was, inter alia, submitted: there is no provision in the Act that TDS provisions shall apply to payment made abroad by a person who is located outside India, breach of such provisions results in severe penal and criminal action and therefore, penal and criminal liability imposition by a statute on foreigners in respect of their acts and omissions committed outside India should not be inferred unless there is a clear-cut provision in the Act to that effect, applicability of TDS provisions to payment made abroad has nothing to do with the taxability of such amount in India, there are various instances where the amounts paid outside India by a foreigner are taxable in India, but such payments are not subject to TDS provisions, etc. Dealing with the provisions of Sec.192(1), it was contended that the same can be divided into two distinct parts. First part creates a legal liability to deduct tax and the second part provides for computation of the amount of tax to be deducted. On a plain and correct reading of the provisions creating liability to deduct tax, the tax is deductible only from the amount paid or payable by the Payer and he is not at all required to deduct tax in respect of the amount paid by any other person. The second part of the provision also refers to only estimated Salary Income of the employee for the whole financial year on the basis of payment made by the Payer (Employer). Other contentions raised were similar to those raised by the earlier counsel.

Another counsel appearing on behalf of M/s. Mitsui & Co. Ltd. also raised similar contentions. However, his main thrust was with regard to penalty imposed under Sec.271C. It was contended that the retention/continuation payment made to expatriates in Japan by Head Office (H.O.) of the Company was not taxable in India and/or TDS provisions are not applicable to such payments. It was further stated that the Company had presented its case before the Department to this effect. However, after consultation with CBDT, it was agreed to pay the tax and accordingly the amount of tax and interest was deposited on the understanding that there will not be any penalty proceeding. Accordingly, both in law and on facts, the Department had erred in imposing penalty. To support his legal stand

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with regard to non-taxability of the amount also, various contentions were raised with reference to the provisions contained in Sec.9(1)(ii) as well as the Explanation introduced by the Finance Act, 1983 (w.e.f. 1.4.1979) and another Explanation introduced by the Finance Act, 1999 (w.e.f. 1.4.2000), to ultimately contend that despite the amendment made by the Finance Act, 1983, a salary paid for 'off-period' was not covered in the provisions and hence another amendment was made, which is prospective in nature. In effect, it seems that an attempt was made to show that taxability of such amount was debatable. The difference between the Branch (Branch Office) on the one hand and H.O. on the other hand recognised for the purpose of implementing TDS provisions was also brought out as, in this case, the expatriates were working at the Project Office in India and were getting salary for rendering services in India and at the same time, they were also getting continuation/retention payments (Home Salary) from the H.O. in Japan.

The Court also noted that the other counsels appearing for various other assessees have adopted the arguments taken up by the earlier counsels.

Questions

1. Study and analyse the case.
2. Write down the case facts.
3. What do you infer from it?

Source: http://www.bcasonline.org/articles/artin.asp?875

7.9 Summary

- As per section 15, salary is taxable on due or receipt basis whichever is earlier. Under Section 15 the income chargeable to income tax under the head salaries would include any salary due to an employee from an employer or a former employer during the previous year irrespective of the fact whether it is paid or not.
- Different forms of salary: (A) Basic Salary: Basic salary is taxable in the hands of an employee. (B) Allowance: An allowance is defined as a fixed amount of money given periodically in addition to the salary for the purpose of meeting some specific requirements connected with the service rendered by the employee or by way of compensation for some unusual conditions of employment. It is taxable on due/accrued basis whether it is paid in addition to the salary or in lieu thereon. (C) Perquisites: The term "perquisites" includes all benefits and amenities provided by the employer to the employee in addition to salary and wages either in cash or in kind which are convertible into money. These benefits or amenities may be provided either voluntarily or under service contract.
- For income-tax purposes, the perquisites are of three types: Tax-free perquisites, Taxable perquisites and Perquisites taxable under specified cases.
- The basic principles governing valuation of perquisites are: the valuation is done on the basis of their value to the employee and not the employer's cost for providing the same, the value of perquisite is included in the salary income only if the perquisite is actually provided to the employee. Perquisite which is not actually enjoyed by the employee (though the terms of employment provide for the same) cannot be valued and taxed in the employee's hands. Therefore, where the employee waives his right of perquisite, he cannot be taxed thereon.
- The following amounts shall be deducted in order to arrive at the chargeable income under the head 'Salaries'. (A) Standard deduction: Omitted (B) Entertainment allowance and (C) Tax on employment or Professional Tax

7.10 Keywords

Accommodation: It includes a house, flat, farm house, hotel accommodation, motel, service apartment, guest house, a caravan, mobile home, ship etc.

Allowance: It is defined as a fixed amount of money given periodically in addition to the salary for the purpose of meeting some specific requirements connected with the service rendered by the employee or by way of compensation for some unusual conditions of employment.

Dearness Allowance, Additional Dearness Allowance and Dearness Pay: This is a very common allowance these days on account of high prices.

Deputation Allowance: When an employee is sent from his permanent place of service to some other place or institution or organisation on deputation for a temporary period, he is given this allowance.

Gratuity: It is a reward for long and meritorious service. Earlier, it was not compulsory for an employer to reward his employee at the time of his retirement or resignation.

Hill Allowance: It is given to employees working in hilly areas on account of high cost of living in hilly areas as compared to plains.

Overtime Allowance: When an employee works for extra hours over and above his normal hours of duty he is given overtime allowance as extra wages.

Perquisite: It includes all benefits and amenities provided by the employer to the employee in addition to salary and wages either in cash or in kind which are convertible into money.

Remote Area: It means an area located at least 40 kilometres away from a town having a population not exceeding 20,000 as per the latest published all-India census.

Salary: It is the remuneration received by or accruing to an individual, periodically, for service rendered as a result of an express or implied contract.

7.11 Review Questions

1. Define Salary.
2. Write a note on basis of charge for salary.
3. Prepare short notes on:
   (a) Profit in lieu of salary
   (b) Entertainment Allowance
4. Differentiate between the following:
   (a) Statutory provident fund and public provident fund.
   (b) House Rent Allowance and Rent Free Accommodation.
   (c) Allowances and Perquisites.
5. Mr. X is employed in P Ltd. getting basic pay of ₹ 20,000 per month. The employer has paid him the following emoluments:

Bonus	6,000 per annum
Servant Allowance	500 per month
Project Allowance	1,000 per month

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Lunch Allowance	300 per month
Transport Allowance	900 per month
Deputation Allowance	1,000 per month
Children Education Allowance (for 3 children)	400 per month
House Rent Allowance (He is living in his own house)	1,000 per month

Compute his gross salary for the assessment year 2013–14

6. Mr. X is employed in ABC Ltd., Amritsar and is getting basic pay of ₹ 11,200 per month, dearness allowance 70% of basic pay (half of it is included for retirement benefits). The employee is working in the purchase department and is allowed commission @ 1.5% on purchase turnover of ₹ 39 lakhs up to 28th February, 2013. Employer has paid house rent allowance of ₹ 5,000 per month. The employee has paid rent of ₹ 3,000 per month. The employee has submitted his resignation with effect from 1st March, 2013. Compute his gross salary for assessment year 2013–14:

7. 'A' furnishes the following details of his salary income for the financial year 2012–13:

   (a) Salary 4,000 p.m.

   (b) Dearness Allowance 500 p.m.

   (c) Entertainment Allowance 200 p.m.

   (d) Employer's and his own contribution to unrecognised Provident Fund 2,600 each

   (e) Interest on the accumulated balance of provident fund @ 12% p.a. 2,600

   (f) City Compensatory Allowance 60 p.m.

   (g) Medical Allowance 1,500 p.a.

   (h) Project Allowance 600 p.m.

   (i) He is also provided with an unfurnished accommodation for which his employer charges ₹ 200 p.m. The fair rent of house is ₹ 12,000 per annum. The house is owned by the employer.

   Compute his taxable income from salary for the assessment year 2013–14.

8. Compute taxable salary income of Mr. Z of Kanpur for the assessment year 2013–14 based on the following information:

Salary @ ₹ 4,000 p.m. (serving since 1.4.1996)	48,000
Entertainment Allowance	5,000
Bonus	10,000
Dearness Allowance (not recognised for computing retirement benefit)	2,000
Employer's contribution to provident fund (recognised)	4,000
Education Allowance for one child	2,700
Lunch Allowance	7,200
Rent-free unfurnished quarters (valued)	6,000
Medical expenses met by employer	600
Reimbursement of hotel bills (necessary for duty)	100

Employee's contribution to Provident Fund	2,000
Premium of Mrs. Z's life policy of ₹ 50,000	6,000
Purchase of books necessary for duty	1,000
Share of HUF	50,000

9. Lata submits the following information regarding her salary income:

Basic salary	₹ 11,000 per month
City compensatory allowance	₹ 150 per month
Children education allowance	₹ 400 per month (for 3 children)
Reimbursement of medical expenses	₹ 25,000

She was entitled to house rent allowance of ₹ 6,000 per month from 1st April, 2011 to 31st August, 2012. However, she was paying a rent of ₹ 7,000 per month for a house in New Delhi. With effect from 1st September, 2012, she was provided with an accommodation by the company for which the company was paying a rent of ₹ 5,000 per month. Compute her gross salary for the assessment year 2013–14.

10. Arnav is working as Accounts Officer with Badri Steels Ltd., Ghaziabad drawing a salary of ₹ 40,000 per month. He gets D.A. @ 12% of salary and entertainment allowance @ ₹ 800 per month. He spends 40% of entertainment allowance on entertaining the customers of the company. The company has provided him the facility of rent-free unfurnished house for which the company pays rent @ ₹ 3,000 per month. The company has provided the services of a cook at the house of Arnav for which the company pays ₹ 1,000 per month as salary. The facility of free refreshment and free meal for 300 days is provided to Arnav costing ₹ 25 per day and ₹ 120 per day respectively during working hours in the office. Arnav and the company both contribute 15% of basic pay and D.A. towards recognised provident fund; ₹ 10,000 is credited to provident fund account by way of interest @ 9% per annum. Compute taxable income from salary of Arnav for the assessment year 2013–14.

Answers: Self Assessment

1. Salary
2. Profit and gains from business
3. Wages
4. Annuity
5. True
6. True
7. False
8. False
9. Allowance
10. Gross salary
11. DA
12. Tiffin allowance
13. Perquisites
14. Specific securities
15. Fair market value
16. Option
17. True
18. True
19. False
20. True
21. True
22. False
23. True
24. False
25. Termination of employment
26. Gratuity

27.	Gratuity Act, 1972	28.	Retrenchment compensation
29.	True	30.	True
31.	False	32.	True

7.12 Further Readings

Books

Aggarwal, K. *Direct Tax Planning and Management.* Atlantic Publications.

Ahuja, G. K. & Gupta, Ravi. *Systematic Approach to Income Tax.*Bharat Law House.

Lakhotia, R. N. *Income Tax Planning Handbook.* Vision Books.

Singhania, V. K. & Singhania, Kapil. *Direct Taxes Law & Practice.* Taxmann Publications.

Srinivas E. A. *Handbook of Corporate Tax Planning.* Tata McGraw Hill.

Online links

http://cptcwa.blogspot.in/2013/02/income-under-head-salary-part-2.html

http://taxguru.in/income-tax/computation-income-head-salaries-including-valuation-perquisites.html

http://www.caclubindia.com/articles/income-from-salary-4997.asp

http://www.caclubindia.com/forum/income-under-the-head-salaries-65770.asp

http://www.moneycontrol.com/tax/salaries/what-is-salarywhat-does-salary-include_622819.html

Unit 8: Income from House Property

Notes

CONTENTS

Objectives

After studying this unit, you will be able to:

- Define the concept of Income from House Property
- Discuss the Applicability of Section 22
- Describe the Computation of income from let out house property
- Explain Computation of annual value or net annual value
- Elucidate the Deductions under Section 24
- Trace the Computation of income from Self-occupied house property
- Identify Some special provisions in computation of Income from House property

Introduction

The provisions for computation of Income from house property are covered under sections 22 to 27. This unit deals with the provisions for computation of Income from house property. Section 22 is the charging section that identifies the basis of charge wherein the annual value is prescribed as the basis for computation of Income from House Property. Therefore, the process of computation of "Income from House Property" starts with the determination of annual value of the property. The concept of annual value and the method of determination are laid down in section 23. The admissible deductions available from house property are mentioned in section 24.

At the end of this unit, you will learn the conditions to be satisfied for income to be chargeable under this head, how to determine the annual value of different types of house properties, admissible deductions and inadmissible deductions from annual value, tax treatment of unrealized rent, who are deemed owners, what is meant by co-ownership and what is its tax treatment etc.

Income from house property is one of the important heads of income under the Income Tax Act. The tax payers have been, in particular, keen to know about the exemptions and deductions available to them on repayment of interest and principal of the loan obtained to purchase the house property, if that house property is let out or self-occupied. The amount of interest on borrowed capital of the current year is available under the head house property further repayment of principal is available under section 80C to individuals and Hindu Undivided Families.

8.1 Income from House Property: An Introduction

Section 22 of the Act provides:

"The annual value of property consisting of any buildings or lands appurtenant thereto of which the assessee is the owner, other than such portions of such property as he may occupy for the purposes of any business or profession carried on by him, the profits of which are chargeable to income-tax, shall be chargeable to income tax under the head Income from House Property".

The following points emerge from the above charging section:

1. ***Tax is charged on income from the buildings or lands appurtenant thereto:*** The buildings include residential buildings, buildings let out for business or profession or auditoriums for entertainment programmes. The location of the building is immaterial. It may be situated in India or abroad.
2. ***Tax is charged on income from lands appurtenant to buildings:*** Where the land is not appurtenant to a building the income from land can be charged as business income or "income from other sources", as the case may be. The lands appurtenant to buildings include approach roads to and from public streets, courtyards, motor garage, compound, playground and kitchen garden. In case of non-residential buildings, carparking spaces, drying grounds or playgrounds shall be the lands appurtenant to buildings.
3. ***Tax is charged from the owner of the buildings and land appurtenant thereto:*** Where the recipient of the income from house property is not the owner of the building, the income is not chargeable under this head but under the head 'Income from Business or Other Sources'. For example, the income to a lessee from sub-letting a house or income to a mortgagee from house property mortgaged to him is not chargeable under the head 'Income from House Property'.

The owner of the buildings may be the legal owner or beneficial owner. In ownership, the ownership of building is considered and not the ownership of income. In certain cases the income may not be received by the owner of the building, still he shall be liable to tax because he is the owner of the building.

Notes The annual value of a property, consisting of any buildings or lands appurtenant thereto, of which the assessee is the owner, is chargeable to tax under the head 'Income from house property'. However, if a house property, or any portion thereof, is occupied by the assessee, for the purpose of any business or profession, carried on by him,

Contd...

the profits of which are chargeable to income-tax, the value of such property is not chargeable to tax under this head.

Thus, three conditions are to be satisfied for property income to be taxable under this head.

1. The property should consist of buildings or lands appurtenant thereto.
2. The assessee should be the owner of the property.
3. The property should not be used by the owner for the purpose of any business or profession carried on by him, the profits of which are chargeable to income-tax.

Self Assessment

Fill in the blanks:

1. According to the Income Tax Act in calculation of income from house property, …………………..include residential buildings, buildings let out for business or profession or auditoriums for entertainment programmes.
2. Where the land is not appurtenant to a building the income from land can be charged as ……………………….
3. Where the recipient of the income from house property is not the owner of the building, the income is chargeable under the head ………………………
4. The income to a lessee from ……………………… a house or income to a mortgagee from house property mortgaged to him is not chargeable under the head 'Income from House Property'.

8.2 Applicability of Section 22

The applicability of the Section 22 in respect to Income from House Property can be stated as under:

Buildings or Lands Appurtenant Thereto

The term 'building' includes residential houses, bungalows, office buildings, warehouses, docks, factory buildings, music halls, lecture halls, auditorium etc.

The appurtenant lands in respect of a residential building may be in the form of approach roads to and from public streets, compounds, courtyards, backyards, playgrounds, kitchen garden, motor garage, stable or coach home, cattle-shed etc., attached to and forming part of the building. In respect of non-residential buildings, the appurtenant lands may be in the form of carparking spaces, roads connecting one department with another department, playgrounds for the benefit of employees, etc.

All other types of properties are excluded from the scope of Section 22. Rental income from a vacant plot of land (not appurtenant to a building) is not chargeable to tax under the head 'Income from house property', but is taxable either under the head 'Profits and gains of business or profession' or under the head 'Income from other sources', as the case may be. However, if there is land appurtenant to a house property, and it is let out along with the house property, the income arising from it is taxable under this head.

Ownership of House Property

It is only the owner (or deemed owner) of house property who is liable to tax on income under this head. Owner may be an individual, firm, company, co-operative society or association of persons. The property may be let out to a third party either for residential purposes or for business purposes. Annual value of property is assessed to tax in the hands of the owner even if he is not in receipt of the income. For tax purposes, the assessee is required to be the owner in the previous year only. If the ownership of the property changes in the relevant assessment year, it is immaterial as the tax is to be paid on the income of the previous year.

Caution Income from subletting is not taxable under section 22.

Example: A owns a house property. He lets it out to be B. B further lets it (or a portion of it) out to C. Rental income of A is taxable under the head 'Income from house property'. However, since B is not the owner of the house, his income is not taxable as income from house property, but as income from other sources under section 56.

Deemed Owner

Section 27 of the Income Tax Act provides that, in certain circumstances, persons who are not legal owners are to be treated as deemed owners of house property for the purpose of tax liability under this head.

1. If an individual transfers a house property to his or her spouse (except in connection with an agreement to live apart) or to a minor child (except a married daughter) without adequate consideration, he is deemed as the owner of the property for tax purposes. However, if an individual transfers cash to his or her spouse or minor child, and the transferee acquires a house property out of the gifted amount, the transferor shall not be treated as the deemed owner of the house property.
2. The holder of an Impartible Estate is deemed to be the owner of all the properties comprised in the estate.
3. A member of a co-operative society, company or association of persons, to whom a property (or a part thereof) is allotted or leased under a house-building scheme of the society, company or associate ion, is deemed to be the owner of such property.
4. A person who has acquired a property under a power of attorney transaction, by satisfying the conditions of section 53A of the Transfer of Property Act, that is under a written agreement, the purchaser has paid the consideration or is ready to pay the consideration and has taken the possession of the property, is the deemed owner of the property, although he may not be the registered owner.
5. A person who has acquired a right in a building (under clause (f) of section 269UA), by way of a lease for a term of not less than 12 years (whether fixed originally or extended through a provision in the agreement), is the deemed owner of the property. This provision does not cover any right by way of a lease renewable from month to month or for a period not exceeding one year Ownership must be of the superstructure. It is not necessary that the assessee is also the owner of the land. Thus, when a person obtains a piece of land on lease and constructs a building on it, the income from such building will be taxed in his hands as income from house property.

Property Used for Own Business or Profession

The owner of a house property is not liable to tax under this head if the property is used by him for his own business or profession. But the business or profession should be such whose income is chargeable to tax. Chargeability to tax does not mean that the income is actually taxed. It is possible that in a particular year the profits are not sufficient enough to attract tax liability. What it means is that the income from such business or profession is not exempt from tax.

If an employer builds quarters for residential use by his employees and the letting out of these quarters is considered as incidental to his business, the income from such property is not taxable under this head, because the property in this case is considered to be used by the owner for his own business. It shall, therefore, be taxed as business income.

The above position will not change even if the buildings are let out to government authorities for locating their undertakings like Banks, Post Office, Police Station, Central Excise Office, etc., provided the dominant purpose of letting out the accommodation is to enable the assessee to carry on his business more efficiently and smoothly. Also, income from paying-guest accommodation is taxable as income from business.

Where house property owned by a partner is used by the firm (neither it is let out to the firm nor any rent is obtained for it) for its business purposes, the partner is entitled to the exemption.

The reason for this exemption is that the notional rent of property is not allowable as a permissible deduction while computing business income, if a person carries on the business or profession in his own house property.

Composite Rent

In some cases, the owner obtains rent of other assets (like furniture) or he charges for different services provided in the building (for instance, charges for lift, security, air conditioning, etc.), apart from obtaining the rent of the building. The amount so recovered is known as composite rent.

If the owner of a house property gets a composite rent for the property as well as for services rendered to the tenants, composite rent is to be split up and the sum which is attributable to the use of property is to be assessed in the form of annual 72 values under section 22. The amount which relates to rendition of the services (such as electricity supply, provisions of lifts, supply of water, watch and ward facilities, etc.) is charged to tax under the head 'Profits and gains of business or profession' or under the head 'Income from other sources'.

If there is letting of machinery, plant and furniture and also letting of the building and the two lettings form part and parcel of the same transaction or the two lettings are inseparable, then such income is taxable either as business income or income from other sources. This happens in the case of letting out of hotel rooms, theatres, auditoriums, etc. It is commonly understood that the charges per day for a room in a hotel are not specifically for the room only. In fact, a major portion of room tariff is for the amenities and services provided in the hotel. Similar is the case where a cinema house is let out at composite rent charged for the building, furniture, machines, equipment, staff, power consumption, etc. In all such cases, the composite rent received by the owner of the property is not to be split up and nothing is taxable as income from house property.

Rental Income of a Dealer in House Property

If a person is engaged in the business of purchasing house properties with the purpose of letting them on high rents and disposing off those properties which are not profitable for this purpose, the rental income from such property will not be taxed as business income. Any rent from house property, whether received by a dealer or a landlord, is taxable under the head 'In come from house property'. It will remain so even if the property is held by the assessee as stock-in-trade of a business or if the assessee is a company which is incorporated for the purpose of building houses and letting them on rent.

Disputed Ownership

If the title of ownership of a house property is disputed in a court of law, the decision as to who is the owner rests with the Inco me-tax Department. Mere existence of dispute as to title cannot hold up an assessment even if a suit has been filed. Generally the recipient of rental income or the person who is in possession of the property is treated as owner.

House Property in a Foreign Country

A resident assessee is taxable under section 22 in respect of annual value of a property in a foreign country. A resident but not ordinarily resident or a non-resident is, however, chargeable under section 22 in respect of income of a house property situated aboard, provided income is received in India during the previous year. If tax incidence is attracted under section 22 in respect of a house property situated abroad, its annual value will be computed as if the property is situated in India.

Did u know? Some incomes from house property are exempt from tax. They are neither taxable nor included in the total income of the assessee for the rate purposes. These are:

1. Income from a farm house [section 2(1A) (c) and section 10(1)].
2. Annual value of one palace in the occupation of an ex-ruler [section 10(19A)].
3. Property income of a local authority [section 10(20)].
4. Property income of an approved scientific research association [section 10(21)].
5. Property income of an educational institution and hospital [section 10(23C)].
6. Property income of a registered trade union [section 10(24)].
7. Income from property held for charitable purposes [section 11].
8. Property income of a political party [section 13A].
9. Income from property used for own business or profession [section 22].
10. Annual value of one self occupied property [section 23(2)]

Self Assessment

Fill in the blanks:

5. ………………………includes residential houses, bungalows, office buildings, warehouses, docks, factory buildings, music halls, lecture halls, auditorium etc.
6. In respect of ……………………..the appurtenant lands may be in the form of carparking spaces, roads connecting one department with another department, playgrounds for the benefit of employees, etc.
7. ………………………from a vacant plot of land (not appurtenant to a building) is not chargeable to tax under the head 'Income from house property'.

8. Income from ……………………… is not taxable under section 22.
9. The holder of an …………………………..is deemed to be the owner of all the properties comprised in the estate.

8.3 Computation of Income from Let Out House Property

Income from let out house property is computed after giving certain deductions from the net annual value of the let out property.

Computation of Net Value of Let Out Property: For let out properties, the gross annual value will be the greatest of the following three amounts.

1. Municipal value of the property;
2. Actual rent received during the year;
3. Fair rent i.e. rent of similar properties in the same or similar locality.

Out of the gross annual value, municipal taxes actually paid during the year have to be deducted to arrive at the net annual value. The municipal taxes are to be deducted in the following cases:

1. The property is let out during the whole or any part of the previous year (There is no such deduction in respect of one self-occupied house property for which 'nil' annual value is adopted
2. The Municipal taxes must be borne by the landlord (If the Municipal taxes or any part thereof are borne by the tenant, it will not be allowed)
3. The Municipal taxes must be paid during the year (Where the municipal taxes become due but have not been actually paid, it will not be allowed. Similarly, the year to which the taxes relate to, is also immaterial).

Under section 24 the following expenses will be allowed as deductions from the net annual value arrived at after deducting municipal taxes from the gross annual value:

1. ***Repairs & Collection Charges – 30% of the Annual Value:*** It is a statutory deduction not dependent on the actual expenditure incurred on repairs or collection by the owner.
2. ***Interest:*** When money is borrowed on interest and the property in question is either acquired or constructed or repaired or reconstructed with such borrowed funds, interest payable thereon is deducted from the annual value. The amount of interest payable for the relevant year should be calculated and claimed as deduction. It is immaterial whether the interest has actually been paid during the year or not.
3. ***Entitled Deductions for Let Out Property:*** The deductions available for computing House Property Income are the following.
    - 30% of the net annual value for repair and maintenance and rent collection expenses for the property
    - Interest on money borrowed to build, buy or repair the property;

Notes

Income from house property is determined as under:

Particulars	Amount
Gross Annual Value	xxxxxxx
Less: Municipal Taxes	xxxxxxx
Net Annual Value	xxxxxxx
Less: Deductions under Section 24	
- Statutory Deduction (30% of NAV)	xxxxxxx
- Interest on Borrowed Capital	xxxxxxx
Income from House Property	xxxxxxx

Self Assessment

State whether the following statements are true or false:

10. Income from let out house property is computed after giving certain deductions from the net annual value of the let out property.
11. For let out properties, the gross annual value will be the lowest of the (a) Municipal value of the property, (b) Actual rent received during the year and (c) Fair rent i.e. rent of similar properties in the same or similar locality.
12. Out of the gross annual value, municipal taxes actually paid during the year have to be deducted to arrive at the net annual value.
13. The Municipal taxes must be borne by the landlord.
14. The Municipal taxes must be paid during the year.

8.4 Computation of Annual Value or Net Annual Value

The basis of calculating Income from House property is the 'annual value'. This is the inherent capacity of the property to earn in come and it has been defined as the amount for which the property may reasonably be expected to be let out from year to year. It is not necessary that the property should actually be let out. It is also not necessary that the reasonable return from property should be equal to the actual rent realized when the property is, in fact, let out. Where the actual rent received is more than the reasonable return, it has been specifically provided that the actual rent will be the annual value. Where, however, the actual rent is less than the reasonable rent (e.g., in case where the tenancy is affected by fraud, emergency, close relationship or such other consideration), the latter will be the annual value. The municipal value of the property, the cost of construction, the standard rent, if any, under the Rent Control Act, the rent of similar properties in the same locality, are all pointers to the determination of annual value.

Gross Annual Value [Section 23(1)]

The following four factors have to be taken into consideration while determining the Gross Annual Value of the property:

1. Rent payable by the tenant (actual rent)

Notes

2. Municipal valuation of the property.

3. Fair rental value (market value of a similar property in the same area).

4. Standard rent payable under the Rent Control Act.

Actual Rent: It is the most important factor in determining the annual value of a let out house property. It does not include rent for the period during which the property remains vacant. Moreover, it does not include the rent that the tax payer is unable to realize, if certain conditions are satisfied. Sometimes a tenant pays a composite rent for the property as well as certain benefits provided by the landlord. Such composite rent is to be disintegrated and only that part of it which is attributable to the letting out of the house property is to be considered in the determination of the annual value.

Municipal Valuation: Municipal or local authorities charge house tax on properties situated in the urban areas. For this purpose, they have to determine the income earning capacity of the property so as to calculate the amount of house tax to be paid by the owner of the property. But this valuation cannot be treated as a conclusive evidence of the rental value of the property, although such valuation is given due consideration by the Assessing Officer.

Fair Rental Value: It is the rent normally charged for similar house properties in the same locality. Although two properties cannot be alike in every respect, the evidence provided by transactions of other parties in the matter of other properties in the neighbourhood, more or less comparable to the property in question, is relevant in arriving at reasonable expected rent.

Standard Rent: Standard Rent is the maximum rent which a person can legally recover from his tenant under a Rent Control Act. This rule is applicable even if a tenant has lost his right to apply for fixation of the standard rent. This means that if a property is covered under the Rent Control Act, its reasonable expected rent cannot exceed the standard rent.

Notes Gross Annual Value (GAV) would be calculated as follows:

Step 1: It includes three things:

- Determine Expected Rent and Actual Rent.
- Expected Rent = Higher of Municipal Value or Fair Rent but subject to Standard Rent
- Actual Rent = Rent for let out period – Unrealised Rent of relevant previous year

Step 2: If actual rent is more than Expected Rent than Actual rent otherwise expected Rent

Step 3: If property remain vacant and annual value decline due to vacancy then such decline value shall be considered

GAV = According to Step 2 (if no vacancy) and According to Step 3 (if vacancy is there)

The Gross Annual Value is the municipal value, the actual rent (whether received or receivable) or the fair rental value, whichever is highest. If, however, the Rent Control Act applies to the property, the gross annual value cannot exceed the standard rent under the Rent Control Act, or the actual rent, whichever is higher.

If the property is let out but remains vacant during any part or whole of the year and due to such vacancy, the rent received is less than the reasonable expected rent, such lesser amount shall be the Annual value.

For the purpose of determining the Annual value, the actual rent shall not include the rent which cannot be realized by the owner. However, the following conditions need to be satisfied for this:

1. The tenancy is bona fide;
2. The defaulting tenant has vacated, or steps have been taken to compel him to vacate the property.
3. The defaulting tenant is not in occupation of any other property of the assessee;
4. The assessee has taken all reasonable steps to institute legal proceedings for the recovery of the unpaid rent or satisfied the Assessing Officer that legal proceedings would be useless.

Caselet

Gross Annual Value Computation in India

Let us find out the Gross Annual Value in the case of the following properties of Mr. Anurag:

Particulars	(1)	(2)	(3)	(4)	(5)
Municipal value	52,000	1, 00,000	60,000	75,000	1, 80,000
Fair rent	60,000	1, 02,000	68,000	70,000	1, 85,000
Standard rent	NA	90,000	70,000	60,000	1, 75,000
Actual rent receivable	55,000	95,000	72,000	72,000	1, 68,000
Unrealized rent	_	_	5,000	_	42,000
Period of vacancy	_	_	_	8 months	1 month

Solution:

(1) Since Rent Control Act is not applicable, GAV will be the highest of municipal value, fair rent and actual rent. Hence, the GAV will be ₹ 60,000.

(2) GAV cannot exceed the standard rent or actual rent, whichever is higher. Therefore, GAV will be ₹ 95,000.

(3) Actual rent receivable will be reduced by the amount of unrealized rent i.e. ₹ 72,000 – ₹ 5,000 = ₹ 67,000. Now, GAV will be the highest of municipal value, fair rent and actual rent, subject to the maximum of standard rent. Hence, GAV will be ₹ 68,000.

(4) GAV will be the actual rent receivable adjusted by the loss due to vacancy i.e. ₹ 72,000 – ₹ 48,000 = ₹ 24,000.

(5) Actual rent receivable will be reduced by the amount of unrealized rent and loss due to vacancy i.e. ₹ 1,68,000 – ₹ 42,000 – ₹ 14,000 = ₹ 1,12,000. Now, we will take the highest of municipal value, fair rent and actual rent, subject 78 to the maximum of standard rent. So, GAV will be ₹ 1,75,000 reduced by the loss due to vacancy i.e. ₹ 1,75,000 – ₹ 14,000 = ₹1,61,000.

Task Find the Gross Annual Value of a house property whose municipal valuation is ₹ 80,000, fair rent is ₹ 90,000 and standard rent is ₹ 75,000. The house is let out to a third party for a monthly rent of ₹ 7,000 for 10 months and remains vacant for the remaining part of the year.

Deduction of Municipal Taxes

From the annual value as determined above municipal taxes are to be deducted if the following conditions are fulfilled:

- The property is let out during the whole or any part of the previous year.
- The Municipal taxes must be borne by the landlord (If the Municipal taxes or any part thereof are borne by the tenant, it will not be allowed).
- The Municipal taxes must be paid during the year (Where the municipal taxes become due but have not been actually paid, it will not be allowed. Similarly, the year to which the taxes relate to, is also immaterial).

Example: No vacancy no unrealized rent

X owns a house property. Municipal value of the house is 1,50,000. The Fair Rent is 1,25,000 and the Standard Rent is 1,45,000. It is let out throughout the previous year for 10,000 p.m. up to December 31,2012 and 14,500 p.m. thereafter. Find out the gross assessment year 2013–14.

Solution:

Municipal Value	(a) 1, 50,000
Fair Rent	(b) 1, 25,000
Standard Rent	(c) 1, 45,000
Actual Rent (10,000 x 9 + 14,500 x 3)	(d) 1, 33,500
Step 1: Expected Rent (a) or (b) whichever is higher, subject to (c)	1, 45,000
Step 2: Gross Annual Value = Higher of Expected or Actual Rent i.e.	1, 45,000

Example: No vacancy but there is unrealized rent

Mr. A owns two houses. The expected rent of the house one is ₹ 65,000. This house was let out for 7,500 p.m. But the rent for the months of Feb. and March 2013 could not be realized. The expected rent of another house is 1,50,000. This house was let out for ₹ 12,000 p.m. But the rent for the last three months could not be realized. In the both cases, Mr. A fulfils the conditions of Rule 4. You are required to compute the Gross Annual Value of both the houses.

Solution:

	House I	House II
Expected Rent	65,000	1, 50,000
Annual Rent	90,000	1, 44,000
Unrealized Rent	15,000	36,000

Computation of Gross Annual Value

Step 1: Expected Rent	65,000	1, 50,000
Step 2: Actual Rent (After deducting unrealized rent) if higher than Expected Rent then Actual rent otherwise Expected rent	75,000	N.A.
Step 3: Applicable only in case of vacancy	N.A.	N.A.
Gross Annual Value	75,000	1, 50,000

Example: There is vacancy but no unrealized rent

Find out the gross annual value in the case of the following properties for the Assessment year 2013–14

Particulars	P	Q	R	S
Expected Rent	70	55	85	125
Rent Per Month (if let out)	7	5	8	8
Let out period (in months)	11	0	9	10
Vacancy (in months)	1	12	3	2

Further all the rents were realized for the year by the assessee.

Solution:

Calculation of Gross Annual Value of Mr. X for A.Y 2013–14	P	Q	R	S
Annual Rent (If let out for 12 months)	84	60	96	96
Loss due to vacancy	7	60	24	16
Unrealized rent	Nil	Nil	Nil	Nil
Actual Rent (for let out period)	77	Nil	72	88
Calculation of Gross Annual Value				
Step 1: Expected Rent	70	55	85	125
Step 2: If actual rent is more than Expected Rent than				
Actual rent otherwise expected Rent	77	N.A.	N.A.	N.A.
Step 3: If property remains vacant then decline due to vacancy shall be considered	40	0	72	109
Gross annual value	70	0	72	109

Self Assessment

Fill in the blanks:

15. The basis of calculating Income from House property is the…………………….
16. The actual rent is …………………the reasonable rent the latter will be the annual value.
17. …………………………..is the most important factor in determining the annual value of a let out house property.

Notes

18. ………………………..is the rent normally charged for similar house properties in the same locality.

19. …………………………is the maximum rent which a person can legally recover from his tenant under a Rent Control Act.

8.5 Deductions under Section 24

Two deductions will be allowed from the net annual value (which is gross annual value less municipal taxes) to arrive at the taxable income under the head 'income from house property'. It has to be borne in mind that the deductions mentioned here (section 24) are exhaustive and no other deductions are allowed. The deductions admissible are as under:

Statutory Deduction

30 per cent of the net annual value will be allowed as a deduction towards repairs and collection of rent for the property, irrespective of the actual expenditure incurred.

Interest on Borrowed Capital

The interest on borrowed capital will be allowable as a deduction on an accrual basis if the money has been borrowed to buy or construct the house. Amount of interest payable for the relevant year should be calculated and claimed as deduction. It is immaterial whether the interest has actually been paid during the year or not. However, there should be a clear link between the borrowal and the construction or purchase etc., of the property. If money is borrowed for some other purpose, interest payable thereon cannot be claimed as deduction.

The following points are to be kept in mind while claiming deduction on account of interest on borrowed capital:

1. In case the property is let out, the entire amount of interest accrued during the year is deductible. The borrowals may be for construction/acquisition or repairs/renewals.
2. A fresh loan may be raised exclusively to repay the original loan taken for purchase or construction etc., of the property. In such a case also, the interest on the fresh loan will be allowable.
3. Interest payable on interest will not be allowed.
4. Brokerage or commission paid to arrange a loan for house construction will not be allowed.
5. When interest is payable outside India, no deduction will be allowed unless tax is deducted at source or someone in India is treated as agent of the non-resident.

Interest Attributable to Period Prior to Construction/Acquisition

Money may be borrowed prior to the acquisition or construction of the property. In such a case, the period commencing from the date of borrowing and ending on the date of repayment of loan or on March 31 immediately preceding the date of acquisition or completion of construction, whichever is earlier, is termed as the pre-construction period. The interest paid or payable for the pre-construction period is to be aggregated and claimed as deduction in five equal instalments during five successive financial years starting with the year in which the acquisition or construction is completed.

Caution This deduction is not allowed if the loan is utilized for repairs, renewal or reconstruction.

Example: X takes a loan of ₹ 10, 00,000 @ 12% p.a. on July1, 2001 for the construction of a house property. The construction of the property is completed on January15, 2004. Calculate the amount of interest deductible in the different previous years.

Solution:

12% of ₹ 10, 00,000 = ₹ 12,000 will be deductible from the annual value of the house property every year till the loan is repaid. Interest for the pre-construction period i.e. from July 1, 2001 to March 31, 2003 (immediately preceding the previous year during which the construction of the house property is completed) will be ₹ 12,000 × 21/12 = ₹ 21,000. It will be deductible in 5 equal instalments of ₹ 4,200 each starting from the previous year in which the construction is completed i.e. 2003–04. Therefore, the total amount deductible as interest on borrowed capital for the first 5 previous years 2003–04, 2004–05, 2005–06, 2006–07 and 2007–08 will be ₹ 12,000 + 4,200 = ₹ 16,200.

Task X took a loan of ₹ 1, 00,000 @ 15% per annum on May 1, 2004 for the construction of his house. The construction of the house was completed on January 31, 2006. Calculate the amount of interest deductible in the previous year 2005–06.

Self Assessment

State whether the following statements are true or false:

20. Two deductions will be allowed from the net annual value to arrive at the taxable income under the head 'Income from house property'.
21. 33 per cent of the net annual value will be allowed as a deduction towards repairs and collection of rent for the property, irrespective of the actual expenditure incurred.
22. In case the property is let out, the entire amount of interest accrued during the year is deductible. The borrowals may be for construction/acquisition or repairs/renewals.
23. A fresh loan may be raised exclusively to repay the original loan taken for purchase or construction etc., of the property. In such a case also, the interest on the fresh loan will be not allowable as deduction.

8.6 Computation of Income from Self-occupied House Property

The annual value of one self-occupied house property, which has not been actually let out at any time during the previous year, is taken as 'Nil' [Section 23(2) (a)]. From the annual value, only the interest on borrowed capital is allowed as a deduction under section 24. The amount of deduction will be:

- Either the actual amount accrued or ₹ 30,000/- whichever is less
- When borrowal of money or acquisition of the property is after 31.3.1999 - deduction is ₹ 1,50,000/- applicable to A.Y 2002–03 and onwards.

However, if the borrowal is for repairs, renewals or reconstruction, the deduction is restricted to ₹ 30,000. If the borrowal is for construction/acquisition, higher deduction as noted above is available.

If a person owns more than one house property, using all of them for self-occupation, he is entitled to exercise an option in terms of which, the annual value of one house property as specified by him will be taken at Nil. The other self occupied house property/is will be deemed to be let out and their annual value will be determined on notional basis as if they had been let out.

Annual Value of One House away from Work Place [Section 23(2) (b)]

A person may own a house property, for example, in Bangalore, which he normally uses for his residence. He is transferred to Chennai, where he does not own any house property and stays in a rental accommodation. In such a case, the house property in Bangalore cannot be used for self-occupation and notional income, therefore, would normally have been chargeable although he derives no benefit from the property. To save the tax payer from hardship in such situations, it has been specifically provided that the annual value of such a property would be taken to be nil subjects to the following conditions:

- The assessee must be the owner of only one house property.
- He is not able to occupy the house property because of his employment, business etc., away from the place where the property is situated.
- The property should not have been actually let or any benefit is derived therefrom.
- He has to reside at the place of employment in a building not belonging to him.

Annual Value of a House Property which is Partly Self-occupied and Partly Let Out

If a house property consists of two or more independent residential units, one of which is self-occupied and the other units are let out, the income from the different units is to be calculated separately. The income from the unit which is self-occupied for residential purposes is to be calculated as per the provisions of Section 23(2)(a) i.e. the annual value will be taken as nil and only interest on borrowed capital will be deductible upto the maximum limit of ₹ 1,50,000 or ₹ 30,000, as the case may be. The income from the let out unit(s) will be calculated in the same manner as the income from any let out house property.

If a house property is self-occupied for a part of the year and let out for the remaining part of the year, the benefit of Section23(2) (a) is not available and the income from the property will be calculated as if it is let out.

Example:

Mr. Ravi owns a house which uses for residential purposes throughout the previous year 2012–13.

Municipal Value	2,40,000
Fair Rent	3,00,000
Compute income from house property assuming following expenditures are incurred by him:	
Municipal taxes paid	15,000
Repairs	12,000

Depreciation	10,000
Interest on borrowed capital (loan taken on 1.1.2000)	2, 00,000

House was purchased on 1.5.2001.

Solution:

Income from House Property	
Net Annual Value	Nil
Less: Interest on borrowed capital	1, 50,000
(Lower of ₹ 2,00,000 or 1,50,000 as conditions are satisfied)	
Loss from House Property	(1, 50,000)

8.6.1 House which is Partly Self-occupied and Partly Let Out

In such a case, the procedure for computation of annual value is as follows:

(a) ***Property let out partially:*** When a portion of the house is self-occupied for the full year and a portion is self-occupied for whole year, the annual value of the house shall be determined as under:

 (i) From the full annual value of the house the proportionate annual value for self-occupied portion for the whole year shall be deducted.

 (ii) The balance under (i) shall be the annual value for let out portion for a part of the year.

Example: Mr. Ram owns a house. The Municipal value of the house is ₹ 50,000. He paid ₹ 8,000 as local taxes during the year. He uses this house for his residential purposes but lets out half of the house @ ₹ 3,000 p.m. Compute the annual value of the house.

Solution:

Annual rent or Municipal valuation (higher)	72,000
Less : Local taxes paid	8,000
Annual value of House Property	64,000
Less : Half of annual value regarding self occupied portion for the whole year	32,000
Annual Value of let out portion	16,000

(b) ***House let out during any part of the previous year and self-occupied for the remaining part of the year:*** In this case the benefit of Section 23(2) is not available and the income will be computed as if the property is let out.

Example: M is the owner of a house. The municipal value of the house is ₹ 40,000. He paid ₹ 8,000 as local taxes during the year. He was using this house for his residential purposes but let out w.e.f. 1.1.2012 @ ₹ 4,000 p.m. Compute the annual value of the house.

Solution:

Annual rent or municipal valuation (whichever is higher)	48,000
Less: Local taxes	8,000

Annual value of the house	40,000

(No benefit shall be given for self occupied period as the house did not remain vacant during the previous year)

Notes If fair rent is not gives, then assume actual rent as fair rent.

(c) ***Self-occupied House Remaining Vacant :*** If the assessee has reserved only one of the houses (owned by him) for his residence or he is the owner of only one house which is meant for his own residence but could not be occupied by him for residential purposes in the previous year owing to the fact that he had to live at some other place in a house not belonging to him, then he can claim non-occupation or vacancy allowance during the previous year for the period during which house remained vacant. The reason for his living at a different place might be for business or professional purposes or for a salaried employee due to transfer etc. The annual value of the house, which remained vacant in these circumstances, shall be nil.

Caution The above mentioned concession will be granted to the assessee only if he has neither let out the said house nor has derived any benefit from it during the period for which it remained vacant. No deduction, except interest on borrowed capital upto a maximum of ₹ 30,000 are allowed in computing income from such a house. This amount of ₹ 30,000 has been increased by Finance Act, 2001 w.e.f. AY 2002–03 to ₹ 1,50,000 where property is acquired or constructed with capital borrowed on or after the 1st day of April 1999 and such acquisition or construction is completed within three years from the end of the financial year in which capital was borrowed.

Self Assessment

Fill in the blanks:

24. The annual value of one self-occupied house property, which has not been actually let out at any time during the previous year, is taken as………………………….
25. From the annual value, only the interest on borrowed capital is allowed as a deduction under………………………
26. When borrowal of money or acquisition of the property is after 31.3.1999 - deduction is ………………. applicable to A.Y 2002–03 and onwards.
27. However, if the borrowal is for repairs, renewals or reconstruction, the deduction is restricted to……………………..

8.7 Some Special Provisions

Some of the special provisions relating to Income generated from house property are as under:

Taxability of Unrealized Rent Recovered Later (Section 25A)

Where any rent cannot be realized, and subsequently if such amount is realized, such an amount will be deemed to be the income from house property of that year in which it is received. We have seen earlier that the basic requirement for assessment of this income is the ownership of the property. However, in the cases where unrealized rent is subsequently realized, it is not necessary that the assessee continues to be the owner of the property in the year of receipt also Assessment of arrears of rent received (Section 25B).

When the owner of a property receives arrears of rent from such a property, the same shall be deemed to be the income from house property in the year of receipt. 30% of the receipt shall be allowed as deduction towards repairs, collection charges etc. No other deduction will be allowed. As in the case of unrealized rent, the assessee need not be the owner of the property in the year of receipt.

House Property Owned by Co-owners (Section 26)

If a house property is owned by two or more persons, then such persons are known as co-owners. Co-owners are not taxable as an association of persons.

When the share of each co-owner is definite and ascertainable, it has been provided that each of the owners will be assessed individually in respect of share of income from the property. In other words, income from the property will be determined and allocated to each co-owner according to his share. When each of the co-owners of a property uses it for his residence, each of them will also get the concessional treatment in respect of one self-occupied property.

Loss from House Property

If the aggregate amount of permissible deductions exceeds the annual value of the house property, there will be a loss from that property. So far as income from a self-occupied property is concerned, and in respect of a property away from the workplace, the annual value is taken at nil and no other deductions are allowed except for interest on borrowed capital upto a maximum of ₹ 30,000 or ₹ 1,50,000. In such cases, there may be a loss up to a maximum of ₹ 30,000 or ₹ 1,50,000, as the case may be. However, in respect of a let out house property, there are no restrictions on deductions and therefore, there can be loss of any amount under this head.

The loss from one house property can be set off against the income from another house property. The remaining loss, if any, can be set off against incomes under any other head like salary. In case the loss does not get wiped out completely, the balance will be carried forward to the next assessment year to be set off against the income from house property of that year. However, such carry forward is restricted to eight assessment years only.

Chart Showing Computation of Taxable Income from House Property

Chart 8.1: Computation of Taxable Income from House Property

Gross Annual Value of the house				XXX
Less: Local Taxes paid by the owner during the previous year			XXX	
Annual Value				XXX
Less: Deduction under Section 24: For house let out or deemed to be let out:				
(i)	Repairs and Collection Charges (30% of Annual Value)		XXX	
(ii)	(a)	Interest on loan, taken for purchase, construction of repair of the house, relating to previous year	XXX	
	(b)	Interest on loan for the period prior to the previous year in which the house is completed is also allowable in five equal annual instalments	XXX	XXX
Taxable Income from House Property				XXX

Example: Mr. X is the owner of four houses. The following particulars are available:

Particulars	House 1	House 2	House 3	House 4
Municipal valuation	16,000	20,000	24,000	5,600
Rent (Actual)	-	14,000	20,000	6,800
Municipal taxes	400	1,000	1,200	300
Repairs and collection charges	200	2,500	1,040	460
Interest on mortgage	—	—	—	1,000
Ground rent	—	100	—	60
Fire premium	140	—	200	—
Annual charges	—	—	360	—

House No. 1 is self-occupied.

House No. 2 is let out for business; construction was completed on 1.3.90 and consists of two residential units.

House No. 3 is 3/4 used for own business 1/4 let out to the manager of the business.

House No. 4 is let out for residential purposes.

His other income is ₹ 30,000. Find out the income of X from house property for the assessment year 2013–14

Solution:

House No. 1

Municipal valuation	16,000
Annual value deemed to be	**NIL**

House No. 2

Fair rental value	20,000
Less: Municipal taxes	1,000
Net annual value	19,000
Less: 30% of Net Annual Value	5,700
	13,300

House No. 3

Since the house is used for own business, the income from this house is not taxable under the head 'Income from house property' but will be assessed under 'Profit and gains of business or profession'. 1/4 of the house occupied by the Manager is presumed to be incidental to the business and hence not assessable under the head 'Income from house property'.

House No. 4

Rent Received	6,800
Less: Municipal taxes	300

Notes

Net annual Value	6,500
Less: 30% of Net Annual Value	1,950
	4,550

Income from House Property: ’ NIL + ₹ 13,300 + ₹ 4,550 = ₹ 17,850. It is presumed that House No. 4 has not been mortgaged for purposes of acquiring or repairs on the house property.

Self Assessment

State whether the following statements are true or false:

28. The basic requirement for assessment of this income is the ownership of the property.
29. In the cases where unrealized rent is subsequently realized, it is not necessary that the assessee continues to be the owner of the property in the year of receipt also Assessment of arrears of rent received.
30. If a house property is owned by two or more persons, then such persons are known as co-owners.
31. If the aggregate amount of permissible deductions exceeds the annual value of the house property, there will be a gain from that property.

Case Study

Developing-a-career-path-in-retail: Whether the compensation received for letting out the manufacturing facilities would be income from house property or business income?

M/s. ABC Rerolling Mills P. Ltd. is carrying on business of manufacturing and selling of rerolled metal articles. It has constructed factory premises on freehold land owned by it. Its main raw material is metal scrap. Due to volatile nature of raw material and finished goods prices, it has been incurring losses and one of the major reasons for losses is that the manufacturing setup is larger than that sustainable by available business.

The company has devised a re-structuring exercise whereby it intends to curtail its manufacturing activities. It is expected that in next three years the business climate would improve and the company would be able to restart manufacturing fully and achieve the same production targets as earlier. This would be a temporary arrangement till the improvement in business environment and financial capacity of the company. It would not totally stop its current manufacturing activities but for the time being it would focus largely on trading activities. It intends to let out its manufacturing facilities to a concern carrying on business of rerolling and simultaneously also carry out own manufacturing on a smaller scale.

The terms of agreement are that the premises including plant and machinery would be let out under a composite agreement for a period of three years with a right to the company to utilise the facilities for particular number of hours in a month. The maximum extension of lease permissible as per the agreement is two years at the option of the lessee.

Contd...

Notes

The lessee shall employ his own workers and pay the electricity and water bills. The company shall retrench 90% of its staff and workers and would employ contractual labour, mostly of the lessee, for the purpose of its own manufacturing. The manufacturing turnover post-letting-out is 20% of the original turnover, though the overall turnover in all trades would probably exceed the existing turnover. A few relevant clauses of the agreement are as follows:

1. ***The clause granting the right of use reads:*** "To conduct and operate the aforesaid Industrial undertaking for carrying out the industrial activity of processing viz. Rerolling at and from the industrial premises and for that purpose (and limited only for that purpose) the owner will permit the conductors to use:
   (a) The said industrial premises,
   (b) The said machinery (described and listed in the said List hereto annexed and marked 'B'), and
   (c) The benefit of the said licences/permits listed in the Statement hereto annexed and marked 'C'."
2. ***Clause 3 of the agreement reads:*** "For the purpose of carrying out the said industrial activities referred to above and limited for that purpose and limited for the duration referred to in clause 2 above, the conductors shall be at liberty:
   (a) Enter and use the said Industrial premises,
   (b) Make use of the said machinery, and
   (c) Avail of the benefit of the said licences and permits.

On the above facts, the company seeks opinion as to whether the compensation received for letting out the manufacturing facilities would be income from house property or business income.

Reply to the Case

Section 22 of the Income-tax Act charges to tax annual value of any building or land appurtenant thereto as income from house property except for such portion of property which is occupied for the purpose of business or profession.

Income for hiring out of property, in most cases would be assessable under the head 'income from house property' except in certain circumstances. For such income to be assessable as business income, the property must have been occupied for the purpose of business carried on. The querist is not in business of hiring out of premises or plant or machinery and therefore it cannot contend that the hiring out is in itself user of premises for business.

However, prior to the proposed restructuring, the property was used for the purpose of business. As such, the issue is whether after the proposed restructuring, the factory premises continue to be occupied for the purpose of business. Before adverting to the law on the subject, let us reiterate the facts of the case:

1. The factory along with plant and machinery were used for the purpose of business of rerolling and there have been losses incurred in the immediate past.
2. The company has been advised that its installed capacity is more than it can utilise.
3. The facilities as a whole have been let out on conductorship basis and the agreement provides that the lessee shall be entitled to use the facilities only for the purpose of rerolling.

Contd...

Notes

4. The duration of the agreement is for a maximum period of three years extendable for a further period of two years only.
5. The lessor shall be entitled to use the facilities for its own manufacturing subject to a maximum number of hours in a month as fixed in the agreement.
6. The company has retrenched 90% of its staff and workers and it shall employ contract labour for the purpose of its own manufacturing.
7. The company shall continue manufacturing on a smaller scale and it shall also continue business of trading.

The issue as to whether income from hiring out of property is business income or income from house property in the circumstances as discussed above, has been considered in a series of cases by the Supreme Court. In a recent decision in the case of Universal Plast v. CIT, (1999) 237 ITR 454 (SC), the Court considered earlier decisions and laid down following tests for determination of the issue:

1. no precise test can be laid down to ascertain whether income (referred to by whatever nomenclature — lease amount, rents, licence fee) received by an assessee from leasing or letting out of assets would fall under the head 'Profits and Gains of business or profession';
2. it is a mixed question of law and in fact has to be determined from the point of view of a businessman in that business on the facts and in the circumstances of each case including true interpretation of the agreement under which the assets are let out;
3. where all the assets of the business are let out, the period for which the assets are let out is a relevant factor to find out whether the intention of the assessee is to go out of business altogether or to come back and restart the same;
4. if only or a few of the business assets are let out temporarily while the assessee is carrying out his other business activities, then it is a case of exploiting the business assets otherwise than employing them for his own use for making profit for that business; but if the business never started or has started but ceased with no intention to be resumed, the assets also will cease to be business assets and the transaction will only be exploitation of property by an owner thereof, but not exploitation of business assets.

Applying the tests to the facts of the case of the querist, it can be said that the letting out of the premises is exploitation of the commercial assets more fruitfully inasmuch as the manufacturing activity is continued though at a reduced scale, the duration of letting out is for a period of three years initially with a maximum extension of further period of two years, and the premises have not been let, rather the manufacturing facility itself along with use of licences and permits has been let out on conductorship basis.

The fact that major part of labour has been retrenched may lead to conclusion that the querist has no intention to restart business. However, in the changing economic scenario when reduction of labour force is no more looked down upon and with even Govt. Undertakings retrenching staff to reduce labour bills, it can be contended that mere retrenchment of staff cannot be a criterion to determine that the company has no intention to restart business.

As such, the querist can contend that letting out of manufacturing facilities is continuation of its business and hire charges are assessable as business income.

Contd...

Notes

Questions

1. Study and analyse the case.
2. Write down the case facts.
3. What do you infer from it?

Source: www.bcasonline.org/articles/artin.asp?235

8.8 Summary

- Section 22 of the Act provides that the annual value of property consisting of any buildings or lands appurtenant thereto of which the assessee is the owner, other than such portions of such property as he may occupy for the purposes of any business or profession carried on by him, the profits of which are chargeable to income-tax, shall be chargeable to income-tax under the head Income from House Property.
- Deemed Owner: As per section 27, the following persons though not the legal owners of a property are deemed to be the owners for the purposes of sections 22 to 26: (a) Transfer to a spouse or minor child, (b) Holder of an impartible estate, (c) Member of a co-operative society, (d) Person in possession of a property and (e) Person having right in a property for a period not less than 12 years.
- The measure of charging income-tax under this head is the annual value of the property, i.e., the inherent capacity of a building to yield income. The expression 'annual value' has been defined in Section 23(1) of the Income-tax Act as, the annual value of any property shall be deemed to be: the sum for which the property might reasonably be expected to let from year to year; or where the property or any part of the property is let and the actual rent received or receivable by the owner in respect thereof is in excess of the sum referred to in clause (a), the amount so received or receivable; or where the property or any part of the property is let and was vacant during the whole or any part of the previous year and owing to such vacancy the actual rent received or receivable by the owner in respect thereof is less than the sum referred to in clause (a), the amount so received or receivable.
- Gross annual value shall be higher of (a) Expected Rent and (b) Actual rent received or receivable. The higher of Municipal value and fair rental value shall be Expected rent. However, expected rent shall not exceed the Standard rent. Net annual value shall be computed in the following manner: Determine the Gross Annual Value, Deduct municipal tax actually paid by the owner during the previous year from the Gross Annual Value.
- Deduction from Annual Value (Section 24): W.e.f. Assessment Year 2002–03, income chargeable under the head "Income from house property" shall be computed after making the following deductions, namely: Standard deduction: a sum equal to 30% of the annual value; Interest on borrowed capital: where the property has been acquired, constructed, repaired, renewed or reconstructed with borrowed capital, the amount of any interest payable on such capital. The interest on borrowed money pertaining to pre-construction period is available in 5 equal instalments commencing from the previous year in which house is acquired or constructed. For this purpose the pre-construction period means the period commencing on the date of borrowing and ending on 31st March immediately prior to the date of completion of construction/date of acquisition or date of repayment of loan, whichever is earlier. Interest for current year is deductible upto ₹ 30,000/₹ 1,50,000 as the case may be.

8.9 Keywords

Annual Value: It is the amount for which the property might be let out on a yearly basis.

Borrowed Capital: These are the funds borrowed from either individuals or institutions.

Building: It includes residential houses, bungalows, office buildings, warehouses, docks, factory buildings, music halls, lecture halls, auditorium etc.

Composite Rent: When the total amount i.e. rent of the building along with the hire charges for other assets such as furniture or service charges for certain services such as security, lift, etc. is received by the owner of the building; such amount so received is defined as Composite Rent.

Deemed Owner: The persons who are not the legal owners of a house property but they are treated as owners of that house property for the purpose of calculation of tax liability.

Fair Rental Value: It is the rent normally charged for similar house properties in the same locality.

Municipal Property Tax: A tax levied against the owner of real or personal property.

Municipal Value of Property: The municipal authorities take into account several factors in order to reach the municipal value. On this amount, the municipal taxes are charged.

Rent Control Act: Under the Rent Control Act, there is a standard rent fixed. It is expected that an owner should not receive rent higher than specified in the Rent Control Act.

Standard Rent: It is the maximum rent which a person can legally recover from his tenant under a Rent Control Act.

8.10 Review Questions

1. Distinguish between
   (a) Gross Annual Value and Annual Value
   (b) Deemed Owners and Actual Owners
   (c) Standard Rent and Expected Rent
   (d) Fair Rent and Annual Rent
2. Discuss the meaning of 'Owner of House Property' under Section 27 of the Income-tax Act, 1961.
3. Define the 'annual value' of house property. How is it computed?
4. In computing the income from house property what deductions are allowed from the net annual value?
5. What is the basis of computation of income from House property? How would you arrive at the net annual value of a house occupied by an assessee for his own residence?
6. How would you deal with the following while calculating the income under 'Income from house property':
   (a) Annual Charge
   (b) Unrealised Rent
   (c) Income from house property situated in a foreign country

Notes

7. Find out income from house property for the assessment year 2013–14 for Amit who owns a house property. Following are the details about the property:

   (a) Municipal value of house: ₹ 72,000 per annum.

   (b) Fair rent of house: ₹ 66,000 per annum.

   (c) Standard rent of house: ₹ 60,000 per annum.

   The house was let out at ₹ 6,000 per month but was sold on 1st January, 2013.

8. Determine the taxable income of Krishan for the assessment year 2013–14.Krishan submits the following information for the assessment year 2013–14:

Property income	House-A	House-B
Municipal valuation	17,500	40,000
Municipal taxes paid by tenant	1,500	2,000
Land revenue paid	1,000	8,000
Rent received	19,000	34,000
Insurance premium paid	250	1,000
Repairs paid by tenant	250	9,000
Interest on borrowed capital for payment of municipal tax of house property	100	200

   Nature of occupation Let out for residence business Date of completion of construction 1.4.1999 1.4.1997

Answers: Self Assessment

1. Building
2. Business income or income from other sources
3. Income from business or other sources
4. Sub-letting
5. Building
6. Non-residential building
7. Rental income
8. Sub-letting
9. Impartible estate
10. True
11. False
12. True
13. True
14. True
15. Annual value
16. Less than
17. Actual rent
18. Fair rental value
19. Standard rent
20. True
21. False
22. True
23. False
24. Nil
25. Section 24
26. 1,50,000
27. 30,000
28. True

29. True
30. True
31. False

8.11 Further Readings

Books

Aggarwal, K. *Direct Tax Planning and Management.* Atlantic Publications.

Ahuja, G. K. & Gupta, Ravi. *Systematic Approach to Income Tax.* Bharat Law House.

Lakhotia, R. N. *Income Tax Planning Handbook.* Vision Books.

Singhania, V. K.& Singhania, Kapil. *Direct Taxes Law & Practice.* Taxmann Publications.

Srinivas E. A. *Handbook of Corporate Tax Planning.* Tata McGraw Hill.

Online links

http://incometaxindia.gov.in/Archive/House_Property_18062012.pdf

http://taxindia.pz10.com/2013/06/income-from-house-property-issues-case.html

http://wircicai.org/wirc_referencer/Income%20Tax%20&%20Wealth%20Tax/Income%20From%20House%20Property.htm

http://www.dnaindia.com/money/1584125/column-how-is-tax-computed-on-rental-income

http://www.flame.org.in/KnowledgeCenter/Taxplanningforyourincomefromhouseproperty.aspx

http://www.moneycontrol.com/tax/property/deductions-allowed-under-incomehouse-property-unde_628453.html

Unit 9: Income under the Head Business and Profession

Notes

CONTENTS

Objectives

After studying this unit, you will be able to:

- Define the concept of business or profession as well as the Basis of its Charge
- Discuss the Profits and losses of speculation business
- Describe the Computation of Profits of Business or Profession

- Explain the Specific deductions under the Income Tax Act
- Trace the Specific Disallowance
- Analyse the concept of Depreciation

Introduction

The provisions for computation of Income from Business and Profession are covered under sections 24 to 44D. This unit deals with the provisions for computation of Income from Business and Profession. Section 28 defines the scope of income which can be taxed under this head. Expenses or allowances expressly allowed by the Act are listed under sections 29 to 37, whereas sections 40, 40A and 43B enumerate those expenses which are expressly disallowed while computing taxable income.

The income from business and profession is known as profit and gains. While calculating the profit and gains, we deduct various expenses from it. The expenses to be deducted for calculating the gain are defined in the income tax act. Sections 30 to 37 cover expenses, which are expressly allowed as deduction while computing business income, sections 40, 40A and 43B cover expenses which are not deductible. Expenses deductions under section 30 to 37 are of two types. The first is specific deductions which are covered under section 30 to 35 and second is general deductions which are covered under section 36 and 37. Specific deductions are allowed only to some of the businesses while general deductions are allowed to all the businesses. There are certain provisions which allow an assessee to calculate the profit on the presumptive basis, i.e., the profit is presumed on certain basis. These provisions are contained under section 44.

9.1 Definition of Business or Profession

The most important head of income is the head 'Profits and gains of Business or Profession'. While the provisions of Sections 28 to 44 D deals with the method of computing income under head "Profits and Gains of Business or Profession".

9.1.1 Meaning of Business

The meaning of the expression 'Business' has been defined in Section 2(13) of the Income-tax Act. According to this definition, business includes any trade, commerce or manufacture or any adventure or concern in the nature of trade, commerce or manufacture. The concept of business presupposes the carrying on of any activity for profit, the definition of business given in the Act does not make it essential for any taxpayer to carry on his activities constituting business for a considerable length of time.

In other words, continuity of the business is not the deciding factor in determining whether an assessee has been carrying on any business or not, for even a single or isolated transaction entered into with the idea of making profit would be a business within the meaning of the definition given in Section 2(13). So long as the activity or enterprise of the assessee can be brought within the meaning of the expression 'any adventure or concern in the nature of trade, commerce or manufacture', the assessee would be said to carry on a business and would consequently be chargeable to tax under this head in respect of the profits and gains derived therefrom.

The concept of business presupposes the existence of the assessee's intention to make a profit out of his transactions. The object to make profit must be inherent in the transaction although the ultimate result of the transaction may be such that the assessee had to incur loss. Thus, the assessability of profits and gains from business under this head does not in any way depend upon the ultimate outcome of the venture or transaction yielding income or loss. A loss incurred from business is as much assessable under this head as profit which is chargeable to tax.

Did u know? There may be cases where a tax payer may acquire an asset not with the idea of selling it at a profit but to retain it as his own investment. In such cases the profit or gain derived from the sale or other transfer of such an investment would constitute a capital profit which cannot be charged to tax under the head 'income from business or profession'.

Caution However, if the same assessee who holds some investments, decides at a later point of time to convert this investment into stock-in-trade and deals with them as part of his business assets in the normal course of his business, the profit or gain derived from the sale of the same asset in the ordinary course of the business would constitute income assessable under this head.

The fact that the asset concerned was originally acquired without the idea of making profit on sale is immaterial for the purpose of assessment. Where a taxpayer acquires an asset with the sole object of making of profit by reselling the asset, but does not sell it for quite some time and later on disposes off the asset at a profit, the profit derived from sale would still be assessable under this head although the assessee had held the asset with him for quite some time.

Thus, the concept of business presupposes an operation consisting substantially of production or sale or purchase and sale or making arrangements for the production, sale etc. of commodities. Thus, an agency which does not involve actual purchases or sale but acts as intermediary would also constitute the carrying on of a business. Therefore, the definition of business given in Section 2(13) is so wide as to cover every case of transaction entered into with the idea of earning income.

In most cases, the concept of business is based upon the idea of the continuous exercise of activities of a series of a similar nature which taken together yield income. But the carrying on of a business for a considerable length of time is not essential for attracting liability to tax under this head because profit derived even from an isolated venture which is in the nature of trade would still be taxable under this head even in cases where the adventure in the nature of trade had come to end or the cost in respect of the venture had been fully recouped to the assessee.

Example: If a person purchases a piece of land, gets it surveyed, lays down a scheme of development, divides it into a number of building plots and sells some of the plots from time to time, he would be chargeable to tax not only on the notional profits made on individual sale of plots but also on the surplus, if any, remaining after the sale of all plots and after the venture had come to an end.

Notes Tax is chargeable on the income of the assessee arrived at after deducting from the sale proceeds the cost of the plots and also the expenses which are incidental thereto.

9.1.2 Meaning of Profession

The expression 'Profession' has been defined in Section 2(36) of the Act to include any vocation. In the case of a profession, the definition given in the Act is very much inadequate since it does not clearly specify what activities constitute profession and what activities do not.

According to the generally accepted principles, the meaning of the term 'profession' involves the concept of an occupation requiring either intellectual skill or manual skill controlled and directed by the intellectual skill of the operator.

Example: An auditor carrying on his practice, the lawyer or a doctor, a painter, an actor, an architect or sculptor, would be persons carrying on a profession and not a business.

Did u know? The common feature in the case of both profession as well as business is that the object of carrying them out is to derive income or to make profit. The process of making the profit would be the main area of difference between the two while the ultimate object is common to both.

9.1.3 Continuity of Business or Profession

As has already been mentioned, the existence of continuity in the business or profession is not an essential condition for making the assessee liable to tax under this head.

Notes Receipts arising from the exercise of a business or profession would still be chargeable to tax under this head although they may be both casual and non-recurring in nature.

Consequently, the exemption available under Section 10(3) for receipt of a casual and non-recurring nature would not be available to income derived from business although carrying on the business would be casual and the receipt of income may be such that it does not recur at all. In determining the taxability of profit under the head business or profession arising from transactions of an isolated nature, the following principle should be taken into account to ascertain whether the transaction is an adventure in the nature of trade:

1. The transaction is said to be in the nature of trade only if some of the elements of trade are found in the transaction, the most important being the object of making profit. It is not essential that all the activities following the main object of the business and which constitute separate transactions by themselves must be entered into with the idea of making profit. In other words, a person whose object is to carry on a business may indulge in certain transactions knowing fully well that he would have to incur loss although he may derive income from the others (e.g. the case of dealer in shares).

2. The purchase of an asset or property with the intention to resell the same may be one of the vital factors in determining the nature of the transaction but the intention to resell at a profit is not to be taken as the only factor for this purpose. This is because of the fact that the cases where the assessee has no intention of enjoying or holding the property, there would be a strong presumption that the transaction is in the nature of trade although this presumption may be rebuttable in certain circumstances depending upon the facts of the case.

Notes

3. It is, however, not possible to evolve a common test or formula which could be applied uniformly in all cases to determine whether a particular transaction is an adventure in the nature of trade or not. The nature of the transaction will have to be determined in each case depending upon the facts or circumstances. The concept of income based upon the principles discussed under Section 4 laying down the principles to be applied for distinguishing between receipts of a capital and revenue nature must be followed even in cases where income is to be computed under this head. In other words, the taxability of income under this head depends primarily upon the fact that the receipt in question is of a revenue nature and is consequently assessable as income under the Act.

Caselet

Athletes Taxation

Mary participates at elite level in a sport which requires heavy expenditure on equipment. She moved from her parent's home, where she normally lived, to a flat which she rents near the sport's national training facilities because it is too far to travel from her parent's home each day. She is in receipt of an Athlete Personal Award of £15,000 and sponsorship income of £5,000. This total funding of £20,000 is however insufficient to meet her training and subsistence expenses which include the costs of the flat. Even though Mary is still only exercising a hobby and not yet trading it is worth noting that if the sponsorship income is received in return for services rendered, and this could simply be an endorsement of certain products, then the £5,000 would be taxable as miscellaneous income.

Mary wins gold at the World Championships and engages an agent to help her exploit her recent success. She is able to secure more sponsorship income and promotional work for a national company.

Mary's sports activities are no longer a hobby for tax purposes. She is now organised in a business-like manner and conducts her sports activities with a view to profit. She is now taxable as she is carrying on a profession.

Mary can deduct from her taxable income (which includes APA; winnings, appearance money etc. from competitions and events; from associated activities undertaken by her e.g. TV appearances and the value of goods or equipment supplied to her), expenses incurred wholly and exclusively for the purpose of her profession e.g. training costs, travel expenses to events etc. or indeed any expenditure incurred solely for business purposes. She will also be able to claim capital allowances on equipment she has purchased for the purpose of her profession. Business purpose must be the sole purpose; any non-business benefit to Mary must be incidental. Whether such expenses are allowable in computing profits will depend on the facts of each case. All expenses claims should be supported by records and documentation.

If an expense is dual purpose, part of the expense may be allowed in computing profits. Subsistence costs such as the flat rental, flat overheads and other living costs are unlikely to be wholly and exclusively for the purposes of Mary's profession. Part of the cost may be deductible if an identifiable part or proportion of the expense is incurred wholly and exclusively for the purpose of Mary's profession. For example if Mary uses a room in her flat exclusively as a gym and to store her sports equipment she may claim a proportion of the rent and other accommodation costs as a business expense.

Source: http://www.hmrc.gov.uk/manuals/bimmanual/bim50606.htm

Self Assessment

Fill in the blanks:

1. The meaning of the expression 'Business has been defined in ………………………… of the Income-tax Act.
2. The concept of business presupposes the carrying on of any activity for ………………………….
3. The expression 'Profession' has been defined in ……………………… of the Act to include any vocation.
4. Receipts arising from the exercise of a business or profession would still be chargeable to tax under head although they may be both ……………………..in nature.

9.2 Basis of Charge

Under section 28, the following income is chargeable to tax under the head "Profits and gains of business or profession":

1. Profits and gains of any business or profession;
2. Any compensation or other payments due to or received by any person specified in section 28(ii);
3. Any income derived by a trade or professional or other similar association from the specific services performed by it for its members;

Did u know? Trade association means an association of businessmen for the protection and advancement of their common interest for instance a Chamber of Commerce.

4. The value of any benefit or perquisite, whether convertible into money or not, arising from business or the exercise of a profession;
5. Export incentive available to exporters;
6. Any interest, salary, bonus, commission or remuneration received by a partner from firm;
7. Any sum received for not carrying out any activity in relation to any business or not to share any know-how, patent, copyright, trademark, etc.;
8. Any sum received under a Key man insurance policy including bonus;

Notes For the purpose of this clause, the expression "Keyman Insurance Policy" shall have the following meaning: "Life Insurance Policy taken by a person on the life of another person who is or was the employee of the first mentioned person or is or was connected in any manner whatsoever with the business of the first mentioned person.

9. Profits and gains of managing agency; and
10. Income from speculative transaction.

Income from the aforesaid activities is computed in accordance with the provisions laid down in sections 29 to 44D.

9.2.1 Method of Accounting

Income under the heads "Profits and gains of business or profession" and "Income from other sources" shall be computed in accordance with method of accounting regularly employed by the assessee.

1. There are two main methods of accounting—mercantile system and cash system.
2. In the case of mercantile system, net profit or loss is calculated after taking into consideration all income and expenditure of a particular accounting year irrespective of the fact whether income is not received or expenditure is not actually paid during the accounting period. Therefore, if books of account are kept by an assessee on the basis of mercantile system, income of a business or profession, accrued during the previous year, is taxable whether it is received during the previous year or in a year preceding or following the previous year. Similarly, expenditure of business or profession, relating to the previous year, is deductible even if it is not paid during the previous year.
3. In the case of cash system of accounting, on the other hand, a record is kept of actual receipts and actual payments of a particular year. If books of account are kept by an assessee on the basis of cash system of accounting, income collected during the previous year is taxable whether it relates to the previous year or a year preceding or following the previous year. Similarly, expenditure actually paid during the previous year is deductible irrespective of the fact whether it relates to the previous year or some other year(s).

Self Assessment

State whether the following statements are true or false:

5. Trade association means an association of businessmen for the protection and advancement of their common interest like a Chamber of Commerce.
6. Life Insurance Policy is taken by a person on the life of another person who is or was the employee of the first mentioned person or is or was connected in any manner whatsoever with the business of the first mentioned person.
7. In the case of mercantile system of accounting, on the other hand, a record is kept of actual receipts and actual payments of a particular year.
8. In the case of cash system of accounting, expenditure actually paid during the previous year is deductible irrespective of the fact whether it relates to the previous year or some other year(s).

9.3 Profits and Losses of Speculation Business

The term 'speculation' has not been exhaustively defined in the income-tax Act, but it normally denotes the meaning commonly assigned to it in commercial practice. However, Section 43(5) defines the expression "speculative transaction" as "a transaction in which a contract for the purchase or sale of any commodity including stocks and shares is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrips".

Where a company (other than banking or financial company) deals in shares of other companies, the income from such business is treated as income from speculative business. However, the following four forms of transactions have been specifically excluded from the scope of speculative transactions:

1. A contract in respect of raw-materials or merchandise entered into by a person in the course of his manufacturing or merchanting business to guard against loss through future

price fluctuations in respect of his contracts for actual delivery of goods manufactured by him or merchandise sold by him; or

2. A contract in respect of stocks and shares entered into by a dealer or investor therein to guard against loss in his holdings of stocks and shares through price fluctuations; or

3. A contract entered into by a member of a forward market or a stock exchange in the course of any transaction which is in the nature of jobbing or arbitrage to guard against any loss which may arise in the ordinary course of his business as such member.

4. An eligible transaction in respect of trading in derivatives referred to in Clause (aa) of Section 2 of the Securities Contracts (Regulation) Act, 1956 carried out in a recognized stock exchange.

Therefore, in all cases where actual delivery or transfer of the commodity takes place, the transaction would not be a speculative transaction, however highly speculative its nature may be. The above-mentioned four items constitute exceptions provided by the Act whereby transactions such as hedging contracts entered into by manufacturer and merchants in the course of their business to guard against the losses through price fluctuations are excluded from the definition of speculative transactions.

Task Discuss whether the transactions such as hedging contracts entered into by manufacturer and merchants in the course of their business to guard against the losses through price fluctuations are included in speculative transactions.

Self Assessment

State whether the following statements are true or false:

9. The term ‘speculation’ has not been exhaustively defined in the income-tax Act.

10. Section 43(5) defines the expression “speculative transaction”.

11. A transaction in which a contract for the purchase or sale of any commodity excluding stocks and shares is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrips is defined as speculative transaction.

12. Where a company deals in shares of other companies, the income from such business is not treated as income from speculative business.

9.4 Computation of Profits of Business or Profession

The profits and gains of business or profession are computed in accordance with the provisions contained in Sections 30 to 43D. Sections 30 to 37 contain those deductions which are expressly allowed while computing profits of business or profession.

Section 40 provides those expenses which are allowed on the basis of general commercial principles while computing profits of business or profession. It is necessary to know those principles before studying the deductions expressly allowed while computing profits of business or profession.

The general commercial principles are as under:

1. Profits should be computed according to the method of accounting regularly employed by the assessee, provided that actual profit can be ascertained by this method, whether on receipt basis or accrual basis.

2. Only those expenses and losses are allowed as deductions which were incurred or sustained during the relevant previous year and related to business.

3. These losses and expenses should be incidental to the operation of the business.

Example: Embezzlement by an employee during the course of business is a loss incidental to the business. Similarly, loss from dacoity in a bank is also a loss incidental to the business of a bank.

4. If a business has been discontinued before the commencement of the previous year, its expenses cannot be allowed as deduction against the income of any other running business of the assessee.

5. There are some essential expenses, though neither expressly allowed nor disallowed, but are deductible while computing the profits of business or profession on the basis of general commercial principles provided that these are not expenses or losses of a capital nature or personal nature.

6. Any expenditure incurred in consideration of commercial expediency is allowed as deduction.

7. Deduction can be made from the income of that business only for which the expenses were incurred. The expenses of one business cannot be charged against the income of any other business.

9.4.1 Rules for Adjustment of Profit and Loss Account Prepared by the Assessee

The Profit and Loss Account prepared by the assessee is not correct from the income tax point of view as (i) several such expenses are charged to it which are wholly or partly inadmissible under the Income-tax Act, (ii) some admissible expenses are omitted from it, (iii) some taxable incomes are not credited to it, and (iv) some such incomes are credited which are either not taxable from taxable point of view, so that the profit taxable under the head 'Business or Profession' is determined correctly. The following are the rules for adjustment of the Profit and Loss Account:

1. Those expenses or losses which are charged to Profit and Loss Account but are not allowed under the Income Tax Act should be added to the profit, as shown by the Profit and Loss Account prepared by the assessee. If any expense is partly disallowed, only the disallowed part of it shall be added to the profit.

2. If any admissible expenses are omitted from Profit and Loss Account, they should be deducted from the above profit.

3. If some taxable incomes are omitted from the Profit and Loss Account they should be added to the above profit.

4. If some such incomes have been credited to the Profit and Loss Account which are either not taxable under the head 'Business or Profession' or are not taxable at all, they should be deducted from the above profits.

Notes If instead of profit there is loss as per the Profit and Loss Account, the above rules shall be reversed, i.e. items to be added shall be deducted and those to be deducted shall be added. If after making some adjustments the profit is converted into loss, the above rules shall be reversed for subsequent adjustments.

9.4.2 Computation of Income under the Head "Profits and Gains from Business or Profession"

The above mentioned rules can well be illustrated with the help of the following statements:

Profit as per P&L A/c

Add:

1. Expenses or losses disallowed but charged in P&L A/c
2. Incomes taxable as business income but not credited to the P&L A/c
3. Expenses in excess of the allowed amount charged in P&L A/c
4. Undervaluation of closing stock or overvaluation of opening stock.

Deduct:

1. Expenses or losses allowed but not debited to P&L A/c
2. Incomes not taxable as business income but credited to the P&L A/c
3. Incomes exempt from tax but credited in P&L A/c
4. Overvaluation of closing stock and undervaluation of opening stock.
5. Taxable Income from Business or Profession

Self Assessment

Fill in the blanks:

13. The profits and gains of business or profession are computed in accordance with the provisions contained in …………………………..
14. ………………………provides those expenses which are allowed on the basis of general commercial principles while computing profits of business or profession.
15. It is necessary to know those principles before studying the …………………………expressly allowed while computing profits of business or profession.
16. ……………………………should be computed according to the method of accounting regularly employed by the assessee, provided that actual profit can be ascertained by this method, whether on receipt basis or accrual basis.

9.5 Specific Deductions under the Income Tax Act

Sections 30 to 37 cover expenses, which are expressly allowed as deduction while computing business income, sections 40, 40A and 43B cover expenses which are not deductible. The following expenses are expressly allowed as deductions against profits and gains of business or profession:

1. ***Rent, rates, taxes, repairs and insurance for building:*** Under section 30, the following deductions are allowed in respect of rent, rates, taxes, repairs and insurance for premises used for the purpose of business or profession:
   (a) the rent of premises, the amount of repairs (not being capital expenditure), if he has undertaken to bear the cost of repairs (this is applicable if the assessee has occupied the property as a tenant);
   (b) the amount of current repairs (not being capital expenditure) (if the assessee has occupied the premises otherwise than as a tenant);

(c) any sum on account of land revenue, local rates or municipal taxes; and

(d) amount of any premium in respect of insurance against risk of damage or destruction of the premises.

Applications of section 43B: Land revenue, local rates or municipal taxes are deductible subject to the conditions as specified by section 43B.

Did u know? In cases where the assessee uses the premises partly for his business or professional purposes and partly for other purposes the deduction allowable under this section is a sum proportionate to that part of the expenses which are attributable to the premises used for business or professional purposes.

2. ***Repairs and insurance of machinery, plant and furniture:*** The expenditure incurred on current repairs (not being capital expenditure) and insurance in respect of plant, machinery and furniture used for business purposes is allowable as deduction under section 31.

3. ***Depreciation:*** Depreciation shall be determined according to the provisions of section 32.

   Conditions for claiming depreciation: In order to avail depreciation, one should satisfy the following conditions:

Table 9.1: Conditions for Claiming Depreciation

Condition 1	Asset must be owned by the assessee.
Condition 2	It must be used for the purpose of business or profession.
Condition 3	It should be used during the relevant previous year.
Condition 4	Depreciation is available on tangible as well as intangible assets.

The asset should be owned by the assessee or the assessee should be the co-owner of the asset. The asset, in respect of which depreciation is claimed, must have been used for the purpose of business or profession.

The asset, in respect of which depreciation is claimed, must have been used for the purpose of business. Normal depreciation (i.e., full year's depreciation) is available if an asset is put to use at least for some time during the previous year. However, depreciation allowance is limited to 50 per cent of normal depreciation, if the following two conditions are satisfied:

a. where an asset is acquired during the previous year; and

b. it is put to use for the purpose of business or profession for less than 180 days during that year.

Tangible assetsIntangible assets acquired after March 31, 1998: Building, machinery, plant or furniture, Know-how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of similar nature.

Depreciation is available on tangible as well as intangible assets: Under the Income-tax Act, one can claim depreciation in respect of the following asset:

a. In case of a tangible asset depreciation can be claimed for assets including Building, machinery, plant or furniture.

b. In case of any intangible asset acquired after March 31, 1998, depreciation can be claimed on assets like Know-how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of similar nature.

Notes Building - "Building" means the superstructure only and does not include site.

Plant - "Plant" includes ships, vehicle, books (including technical know-how report), scientific apparatus and surgical equipment used for the purpose of business or profession. It does not include tea bushes or livestock or buildings or furniture and fittings.

Consequences when above conditions are satisfied: If the above conditions are satisfied, depreciation is available. Depreciation is available whether or not the assessee has claimed the deduction for depreciation in computing his total income.

To understand method of computation of depreciation, one must know the meaning of the following terms:

- Block of assets
- Written down value
- Actual cost

Block of assets [sec. 2(11)]: The term "block of assets" means a group of assets falling within a class of assets comprising —

a. tangible assets, being buildings, machinery, plant or furniture;

b. intangible assets, being know-how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of similar nature, in respect of which the same percentage of depreciation is prescribed. A taxpayer may have 19 different blocks of assets.

Written down value [sec. 43(6)]: Written down value for an assessment year will be determined as under:

Step 1: Find out the depreciated value of the block on the April 1 of the Previous year.

Step 2: To this value, add "actual cost" of the asset (falling in the block) acquired during the previous year.

Step 3: From the resultant figure, deduct money received/receivable (together with scrap value) in respect of that asset (falling within the block of assets) which is sold, discarded, demolished or destroyed during the previous year.

Notes Other points: The following points should be noted:

a. The resulting amount is the written down value of the block of assets on March 31 relevant for the assessment year.

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

c. One may determine written down value for other assessment years on similar basis.

d. In some cases, computation of written down value is based upon notional figures.

e. Under Step 3 only actual money (received or receivable in cash or by cheque or draft) is deductible. In other words, any other things or benefit (which can be converted in terms of money) cannot be deducted under Step 3.

In the cases given below, the above-mentioned rule is not applicable:

Table 9.2: Exceptions to the Rule of Providing Depreciation

Exception 1	If written down value of the block of asset is reduced to zero, though the block is not empty
Exception 2	If the block of assets is empty or ceases to exist on the last day of the previous year (though the written down value is not zero)
Exception 3	If in the first year in which an asset is acquired, it is put to use for less than 180 days

The concept of depreciation since holding lot of importance in income from business and profession is discussed in detail in later sections of this unit.

4. ***Expenditure on scientific research:*** The term "scientific research" means "any activity for the extension of knowledge in the fields of natural or applied sciences including agriculture, animal husbandry or fisheries". With a view to accelerating scientific research, section 35 provides tax incentives. Under this section amount deductible in respect of scientific research may be classified as under:

Table 9.3: Amount Deductible in Respect of Scientific Research

Expenditure on research carried on by the assessee	Contribution to outsiders
1. Revenue expenditure under section 35(1)(i) 2. Capital expenditure under section 35(2) 3. Expenditure on an approved in-house research under section 35(2AB)	1. Contribution to an approved scientific research association under section 35(1)(ii)l(iii) 2. Payment to National Laboratory under section 35(2AA)

Revenue expenditure incurred by the assessee himself [sec. 35(1) (i)]: Where the assessee himself carries on scientific research and incurs revenue expenditure, deduction is allowed for such expenditure only if such research relates to the business.

Example: Suppose X Ltd. is engaged in the business of manufacture of paper and it incurs revenue expenses for conducting scientific research for improving the quality of steel, such expenditure is not deductible, as it is not related to the business of the taxpayer.

Contribution made to outsiders [sec. 35(1)(ii)1(iii)]: Where the assessee does not himself carry on scientific research but makes contributions to other institutions for this purpose, a weighted deduction is allowed. The amount of deduction is equal to one and one-fourth times of any sum paid to a scientific research association or to a university, college or other institution if F

a. the payment is made to an approved scientific research association which has, as its object, undertaking of scientific research related or unrelated to the business of the assessee [sec. 35(1) (ii)];

b. the payment is made to an approved university, college or institution for the use of scientific research related or unrelated to the business of the assessee [sec. 35(1) (ii)]; and

c. the payment is made to an approved university, college or institution for the use of research for social science or statistical research related or unrelated to the business of the assessee [sec. 35(1)(iii)].

Approval under section 35(1) (ii)l (iii) is given by the Central Government and not by a prescribed authority.

Capital expenditure incurred by an assessee himself [sec. 35(2)]]: Where the assessee incurs any expenditure of a capital nature on scientific research related to his business, the whole of such expenditure incurred in any previous year is allowable as deduction for that previous year.

Notes One should note the following points:

1. If an assessee incurs capital expenditure on scientific research related to his business, then deduction is available even if the relevant asset is not put to use for research and development purposes during the previous year.
2. The above expenses may be on plant or equipment for research or constructing building (excluding cost of land) for research or expenses of capital nature connected with research like expenses on purchase of buses to transport research personnel.
3. Where any capital expenditure has been incurred on scientific research related to business before the commencement of business, the amount of such expenditure, incurred within three years immediately preceding the commencement of the business, is deductible in the previous year in which the business is commenced [Explanation to section 35(2)(i)].
4. The aforesaid deduction is not available in respect of capital expenditure incurred on the acquisition of any land.
5. No deduction by way of depreciation is admissible in respect of an asset used in scientific research.
6. If the asset is sold without having been used for other purposes, surplus (i.e., sale price) or deduction already allowed under section 35, whichever is less, is chargeable to tax as business income of the previous year in which the sale took place [section 41(3)]. The excess of sale price over cost of acquisition (or indexed cost of acquisition) is chargeable to tax under section 45 under the head "Capital gains".

Contribution to national laboratory [sec. 35(2AA)]: The payment is made to National Laboratory; or University; or Indian Institute of Technology; or Specified person as approved by the prescribed authority for undertaking scientific research programme.

Amount of deduction: If the aforesaid conditions are satisfied, the taxpayer is eligible for weighted deduction, which is equal to one and one fourth times of actual payment. Such contribution, which is eligible for weighted deduction, is not eligible for any other deduction under the Act.

Expenditure on in-house research and development expenses [sec. 35(2AB)]: Section 35(2AB) provides for a weighted deduction in respect of expenditure on in-house research and development expenses subject to the following conditions:

1. The taxpayer is a company.
2. It is engaged in the specified business.
3. It incurs any expenditure on scientific research and such expenditure is of capital nature or revenue nature (not being expenditure in the nature of cost of any land and building).
4. The above expenditure is incurred on in-house research and development facility up to March 31, 2007.

5. The research and development facility is approved by the prescribed authority.

6. The taxpayer gets audit of the accounts maintained for such a facility.

   Amount of deduction: If all the above conditions are satisfied, then a sum equal to one and one-half times of the expenditure so incurred shall be allowed as deduction.

5. ***Amortisation of preliminary expenses:*** Certain preliminary expenses are deductible under section 35D.

   Who can claim deduction: Deduction under section 35D is available in case of an Indian company or a resident non-corporate assessee. A foreign company even if it is resident in India, cannot claim any deduction under section 35D.

   Time and purpose of preliminary expenses: Expenses incurred at the following two stages are qualified for deduction under section 35D:

Table 9.4: Expenses Qualifying for Deductions under Section 35D

When expenses are incurred	Why expenses are incurred
1. Before commencement of business	For setting up any undertaking or business
2. After commencement of business	In connection with extension of an industrial undertaking or in connection with setting up a new industrial unit

Did u know? Deduction under section 35D is not available in respect of expenditure incurred after commencement of business if such expenditure is incurred in connection with extension of (or setting up) a non-industrial undertaking.

Qualifying expenditure: The heads of qualifying expenditure are the following:

- ❖ Expenditure in connection with preparation of feasibility report, preparation of project report, conducting a market survey (or any other survey necessary for the business of the assessee), etc.
- ❖ Legal charges for drafting any agreement.
- ❖ Legal charges for drafting the memorandum and articles of association.
- ❖ Printing expenses of the memorandum and articles of association.
- ❖ Registration fees of a company under the provisions of the Companies Act.
- ❖ Expenses in connection with the public issue of shares or debentures of a company, underwriting commission, brokerage and charges for drafting, typing, printing and advertisement of the prospectus.
- ❖ Any other expenditure, which is prescribed.

Qualifying expenditure - Maximum ceiling: The aggregate expenditure cannot exceed the following:

Table 9.5: Maximum Ceiling on Expenditure

In the case of a corporate assessee	In the case of a non-corporate assessee
a. 5 per cent of cost of project; or	5 per cent of cost of project
b. 5 per cent of capital employed, whichever is more	

Notes Cost of project means the actual cost (or additional cost incurred after commencement of business in connection with extension or setting up an industrial undertaking) of fixed assets, namely, land, buildings, leaseholds, plant, machinery, furniture, fittings and railway sidings (including expenditure on development of land and buildings), which are shown in the books of the assessee as on the last day of the previous year in which the business of the assessee commences.

Capital employed in the business of a company: It means the aggregate of the issued share capital, debentures and long-term borrowings, as on the last day of the previous year in which the business of the company commences.

Amount of deduction: One-fifth of the qualifying expenditure is allowable as deduction in each of the five successive years beginning with the year in which the business commences, or as the case may be, the previous year in which extension of the industrial undertaking is completed or the new industrial unit commences production or operation.

6. ***Bonus or commission to employees:*** Bonus or commission paid to an employee is allowable as deduction subject to certain conditions:
   - ***Admissible only if not payable as profit or dividend:*** One of the conditions is that the amount payable to employees as bonus or commission should not otherwise have been payable to them as profit or dividend.
   - ***Deductible on payment basis:*** Bonus or commission is allowed as deduction only where payment is made during the previous year or on or before the due date of furnishing return of income under section 139.
7. ***Interest on borrowed capital:*** Interest on capital borrowed is allowed as deduction if the following conditions are satisfied:

Table 9.6: Conditions for Interest on Borrowed Capital

Condition 1	The assessee must have borrowed money.
Condition 2	The money so borrowed must have been used for the purpose of business.
Condition 3	Interest is paid or payable on such borrowing.

General Deduction

Section 37(1) is a residuary section. In order to claim deduction under this section, the following conditions should be satisfied:

Table 9.7: Conditions for General Deductions

Condition 1	The expenditure should not be of the nature described under sections 30 to 36.
Condition 2	It should not be in the nature of capital expenditure.
Condition 3	It should not be personal expenditure of the assessee.
Condition 4	It should have been incurred in the previous year.
Condition 5	It should be in respect of business carried on by the assessee.
Condition 6	It should have been expended wholly and exclusively for the purpose of such business.
Condition 7	It should not have been incurred for any purpose, which is an offence or is prohibited by any law.

Task Discuss whether the following expenses allowable as deduction under section 37(1):

1. Litigation expenses for official purposes.
2. Expenses relating to purchase of stationary for official purpose.
3. Interest on loan taken for the purpose of paying income-tax.

Self Assessment

Fill in the blanks:

17. …………………………..deals with the deductions are allowed in respect of rent, rates, taxes, repairs and insurance for premises used for the purpose of business or profession.
18. The expenditure incurred on current repairs (not being capital expenditure) and insurance in respect of plant, machinery and furniture used for business purposes is allowable as deduction under……………………………..
19. …………………………………means the superstructure only and does not include site.
20. ………………………………is defined as any activity for the extension of knowledge in the fields of natural or applied sciences including agriculture, animal husbandry or fisheries etc.

9.6 Specific Disallowance

The following expenses given by sections 40, 40A and 43B are expressly disallowed by the Income Tax Act while computing income chargeable under the head "Profits and gains of business or profession".

9.6.1 Expenses Disallowed (Section 40)

The following amounts shall not be deducted in computing the income chargeable under the head "profits and gains of business or profession:

1. ***Interest Payable Outside India:*** Under Section 40(a)(i), deduction is not allowed in respect of an interest (not being interest on a loan issued for public subscription before 1.4.1938), royalty, fees for technical services or other sum chargeable under the Income-tax Act, which is payable outside India or in India to a non-resident, not being a company or to a foreign company and on which tax has not been deducted or after deduction, has not been paid before the expiry of the time prescribed under Subsection (1) of Section 200. In case where tax is paid or deducted in a subsequent year, the benefit of deduction from profit and gains from business and professional income will be allowed in computing the income of the previous year in which such tax has been paid.
2. ***TDS not Deducted on Certain Payments:*** Any interest, commission or brokerage, rent, royalty, fees for professional services or fees for technical services payable to a resident, or amounts payable to a contractor or sub-contractor, being resident, for carrying out any work (including supply of labour for carrying out any work), on which tax is deductible at source under Chapter XVIIB and such tax has not been deducted or, after deduction, has not been paid on or before the due date specified in sub-section (1) of section 139.

Caution Provided that where in respect of any such sum, tax has been deducted in after the due date specified in sub-section (1) of section 139, such sum shall be allowed as a deduction in computing the income of the previous year in which such tax has been paid.

Provided further that where an assessee fails to deduct the whole or any part of the tax in accordance with the provisions of Chapter XVII-B on any such sum but is not deemed to be an assessee in default under the first proviso to sub-section (1) of section 201, then, for the purpose of this sub-clause, it shall be deemed that the assessee has deducted and paid the tax on such sum on the date of furnishing of return of income by the resident payee referred to in the said provision.

3. ***Rate or Tax Paid on Profits:*** Under Section 40(a)(ii), any sum paid by the assessee on account of any tax or rate levied on profits on the basis of or in proportion to the profits and gains of any business or profession, would be disallowed in full.

Example: Income-tax, foreign income-tax or a professional tax levied under the Municipal Act on persons who exercise a profession, trade or calling within the municipal limit shall be disallowed.

4. ***Wealth Tax [Section 40a(iia)]:*** Any wealth-tax paid or payable by the assessee in respect of his business assets would be totally disallowed. It is immaterial whether the wealth-tax is assessed and payable in India or in foreign country in respect of the business assets of the assessee.

Notes However, any tax on business assets (other than wealth-tax) is deductible.

5. ***Salaries [Section 40a(iii)]:*** Any payment which is chargeable under the head "salaries" if it is payable:

   a. outside India; or

   b. to a non-resident and if the tax has not been paid thereon or deducted thereon under Chapter XVIIB of the Act.

6. ***Payment to Provident Funds etc. [Section 40a(iv)]:*** Any payment to a Provident Fund or other fund established for the benefit of employees of the assessee would be disallowed in cases where the assessee (employer) has not made effective arrangements to secure deduction of tax at source from any payment made from the fund which are chargeable to tax under the head 'salaries' in the hands of the employees.

7. ***Payment of Tax on Non-monetary Perquisites [Section 40a(v)]:*** Tax actually paid by an employer under Section 10(10CC) shall not be deducted in computing the income chargeable under the head "Profit and gains of business or profession".

8. ***Payment to Partners:*** The new provision of Section 40(b) which is substituted by the Finance Act, 1992 with effect from the assessment year 1993–94, provides as follows: In the case of a firm which is assessable as such:

   a. any payment of salary, bonus, commission or remuneration by whatever name called to a partner other than a working partner would not be allowed as deduction in the hands of the firm;

   b. any remuneration paid to a working partner or interest paid to any partner, which is not authorised by or not in accordance with the terms of the partnership deed would not be allowable deduction in the hands of the firm;

c. any remuneration paid to a working partner or interest paid to any partner which is authorised by or is in accordance with the terms of the partnership deed but which relates to any period falling prior to the date of such partnership deed would not be allowable. However, in relation to any payment of remuneration to the partner during the previous year relevant to the assessment year 1993–94, the terms of the partnership may at any time during the said previous year, provide for such payment.

d. any interest which is paid in accordance with the terms of the partnership deed and relates to any period falling after the date of such partnership deed but which is in excess of simple interest @ 12% p.a., w.e.f. 1.6.2002 would not be allowable.

   Further, interest paid by the firm to a person in his representative capacity (i.e. on behalf or for the benefit of any other person) and the interest paid by the firm to the person who is so represented shall also be subject to the limit laid down in this clause.

   However, where a person is a partner in his representative capacity in the firm, the interest paid to him by the firm otherwise than as partner in a representative capacity will not be subject to the limit laid down in this clause. Again, where a person is a partner in a firm in his own capacity (and not as a partner in a representative capacity), interest paid by the firm to him shall not be taken into account for the purposes of this clause if such interest is received by him on behalf of or for the benefit of any other person.

e. any remuneration to a working partner which is authorised by and is in accordance with the terms of the partnership deed and in relation to any period falling after the date of partnership deed is an allowable deduction subject however, to the condition that the maximum amount of such payment made to all the partners during the previous year should not exceed the limits given below:

Quantum of Book Profit Amount

- Upto ₹ 3,00,000 or in ₹ 1,50,000 or 90% of the Book case of a loss profit, whichever is more
- on the balance 60% For the purposes of this clause, 'working partner' means an individual who is actively engaged in conducting the affairs of the business or profession of the firm of which he is a partner; and 'Book profit' means the net profit, as shown in the profit and loss account for the relevant previous year, computed in the manner laid down in chapter IV-D (i.e. Sections 28 to 44D) as increased by the aggregate amount of remuneration paid or payable to all the partners of the firm if such amount has been deducted while computing the net profit.

9. ***Payment by AOPs / BOIs [Section 40(ba)]:*** In the case of an association of persons or body of individuals (other than a company or a Co-operative Society or a society registered under the Societies Registration Act, 1860, or under any law corresponding to that Act in force in any part of India) any payment of interest, salary, bonus, commission or remuneration, by whatever name called, made by such association or body to a member of such association or body shall not be allowed as a deduction.

Did u know? Where an individual is a member otherwise than as a member in a representative capacity of an AOP or BOI, interest paid to such person by the AOP or BOI shall not be taken into account for the purposes of this clause if such interest is received by the person on behalf of or for the benefit of any other person.

9.6.2 Expenses Restricted

The expenses restricted include the following:

1. ***Payment to Relatives or Associates [Section 40A(2)]:*** Where the assessee incurs any expenditure in respect of which payment has been or is to be made to any person specified below and the Assessing Officer is of the opinion that such expenditure is excessive or unreasonable, having due regard to the fair market value of the goods, services or facilities for which the payment is made or the legitimate needs of the business or profession of the assessee or the benefit derived by or accruing to him therefrom, so much of the expenditure as is considered to be excessive or unreasonable must be disallowed in computing the assessee's income from business or profession.

   However, no disallowance, on account of any expenditure being excessive or unreasonable having regard to the fair market value, shall be made in respect of a specified domestic transaction referred to in section 92BA, if such transaction is at arm's length price as defined in clause (ii) of section 92F.

Notes **Meaning of specified domestic transaction (Section 92BA)**

For the purposes of this section and sections 92, 92C, 92D and 92E, "specified domestic transaction" in case of an assessee means any of the following transactions, not being an international transaction, namely:

- any expenditure in respect of which payment has been made or is to be made to a person referred to in clause (b) of sub-section (2) of section 40A;
- any transaction referred to in section 80A;
- any transfer of goods or services referred to in sub-section (8) of section 80-IA;
- any business transacted between the assessee and other person as referred to in sub-section (10) of section 80-IA;
- any transaction, referred to in any other section under Chapter VI-A or section 10AA, to which provisions of sub-section (8) or sub-section (10) of section 80-IA are applicable; or
- any other transaction as may be prescribed, and where the aggregate of such transactions entered into by the assessee in the previous year exceeds a sum of five crore rupees.

The specified persons, the payments to whom may fall for disallowance under this section are the following:

- Where the assessee is an individual - any relative of the assessee.
- Where the assessee is a company, firm, association of persons or H.U.F. any director of the company partner of the firm, member of the association or family, or any relative of such director, partner or member.
- Any individual who has a substantial interest in the business or profession of the assessee or any relative of such individual.
- A company, firm, association of persons or H.U.F. having substantial interest in the business or profession of the assessee or any director, partner or member of such

Contd...

company, firm, association or family or any relative of such director, partner, or member as the case may be or any other company carrying on business or profession in which the first mentioned company has substantial interest.

- A company, firm, association of persons or H.U.F. of which a director, partner or member, as the case may be, has substantial interest in the business or profession of the assessee or any director, partner or member of such company, firm, association or family or any relative of these persons.
- Any person who carries on a business or profession in cases where the assessee is an individual or any relative of the individual or a person having substantial interest in the business or profession of that person or where the assessee is a company, firm, association of persons or H.U.F. any director of such company, partner of such firm, member of the association or family, or any of their relatives who has a substantial interest in the business or profession of that person.

2. ***Cash Payments Exceeding ₹ 20,000 [(Section 40A(3)]:*** Where the assessee incurs any expenditure in respect of which a payment or aggregate of payments made to a person in a day, otherwise than by an account payee cheque drawn on a bank or account payee bank draft, exceeds twenty thousand rupees, no deduction shall be allowed in respect of such expenditure.

   Where an allowance has been made in the assessment for any year in respect of any liability incurred by the assessee for any expenditure and subsequently during any previous year (hereinafter referred to as subsequent year) the assessee makes payment in respect thereof, otherwise than by an account payee cheque drawn on a bank or account payee bank draft, the payment so made shall be deemed to be the profits and gains of business or profession and accordingly chargeable to income-tax as income of the subsequent year if the payment or aggregate of payments made to a person in a day, exceeds twenty thousand rupees.

3. ***Provision for Gratuity [Section 40A(7)]:*** No deduction shall be allowed in respect of any provision made by the assessee for the payment of gratuity to his employees on their retirement or termination of their employment for any reason. However, any provision made by the assessee for the payment of a sum by way of any contribution towards an approved gratuity fund or for the purpose of payment of any gratuity that has become payable during the previous year shall be allowed.

Did u know? Where any provision made by the assessee for the payment of gratuity to his employees on their retirement or termination of their employment for any reason has been allowed as a deduction in computing the income of the assessee for any assessment year, any sum paid out of such provision by way of contribution towards an approved gratuity fund or by way of gratuity to any employee shall not be allowed as a deduction in computing the income of the assessee of the previous year in which the sum is so paid.

4. ***Restriction on Contribution by Kmployers to Non-statutory Funds [Sections 40A(9), (10) and (11)]:*** With a view to discouraging creation of irrevocable or discretionary trusts funds, companies, associations of persons, societies, etc. the Finance Act, 1984 has provided that no deduction shall be allowed in the computation of taxable profits in respect of any sums paid by the assessee as an employer towards the setting up or formation of or as contribution to any fund, trust, company, association of persons, body of individuals or society or any other institution for any purpose, except where such sum is paid by the assessee as an employer towards the setting up or formation of or as contribution to any fund, trust, company, association of persons, body of individuals or society or any other institution for any purpose, except where such sum is paid or contributed (within the

limits laid down under the relevant provisions) to a recognised provident fund or an approved gratuity fund or an approved superannuation fund or for the purposes of and to the extent required by or under any other law.

It is further provided that where the Assessing Officer, is satisfied that the fund, trust, company, association of persons, body of individuals, society or other institution referred above has, before March 1, 1984 bona fide laid out or expended any expenditure (not being in the nature of capital expenditure) wholly or exclusively for the welfare of the employees of the assessee out of the sum referred above, the amount of such expenditure shall, in case no deduction has been allowed to the assessee in respect of such sum, be deducted in computing the business income of the assessee of the previous year in which such expenditure is so laid out or expended. It is also provided that where the assessee has before March 1, 1984, paid any sum to any fund, trust, company, association of persons, body of individuals, society or other institutions, then notwithstanding anything contained in any other law or in any instrument, he would be entitled:

- to claim the unutilised amount be repaid to him and where any claim is so made, the unutilised amount shall be repaid, as soon as may be, to him; and
- to claim that land, building, machinery, plant and furniture acquired or constructed by the fund, trust, company, association of persons, body of individuals, society or other institution out of the sum paid by the assessee, be transferred to him and where any claim is so made, such asset shall be transferred, as soon as may be to him.

Caution The aforesaid provisions took effect retrospectively from 1st April, 1980, and accordingly, apply in relation to the assessment year 1980–81 and subsequent years.

9.6.3 Disallowance of Unpaid Statutory Liability (Section 43B)

Under the income-tax law, a person carrying on a business or profession can account for his income either on cash or mercantile basis. The latter, however, have to reckon with the restrictions contained in Section 43B. This section cuts into the freedom of a business to claim certain specified expenses on due basis. The section has broadly divided the targeted expenses into two i.e., according to section 43B even if an assessee maintains books on mercantile system then he will be allowed exemption of the following expenses only on payment basis.

In the first category are:

(a) taxes, duties, cess or fees payable under any law;

(b) bonus and commission to employees;

(c) interest to public financial institutions, state financial corporations, state industrial investment corporations and to scheduled banks in respect of term loans or advances;

(d) leave encashment.

(e) any sum payable by employer by way of contribution to provident fund or super annuation fund or any other fund for welfare of employees.

These four sets of expenses outstanding at the end of the previous year would be allowed as deduction only to the extent they have been actually paid on or before the due date of filing the income-tax return failing which they would be allowed in the previous year they have been actually paid. Where interest as stipulated in (d) above is converted into a loan, borrowing or advance and is not paid, interest so converted will not be treated as having been actually paid, and accordingly, will not be allowed as a deduction from business income.

The second category deals with employers' contribution to provident fund superannuation fund, gratuity fund or any other fund for the welfare of employees. No deduction on this account shall be allowed unless payment is made to the appropriate authority like the Provident Commissioner in case of PF contribution on or before the due date set out in the relevant statute like the PF Act. In case, the payment was made otherwise than by cash; the sum should have been realised within 15 days of such due date.

Example: If PF contributions are to be handed over to the relevant authority within a month from the end of the month in which it was deducted from employees' salary and the employer for the month of August '99 deductions makes the payment say in the month of October '99, he will lose the benefit of deduction in so far as contributions to PF for the month of August '99 are concerned.

However, Finance Act, 2003 has omitted the second proviso and therefore PF and ESI contribution will be allowed as deduction even if they are not paid within due date specified under relevant Acts.

Self Assessment

Fill in the blanks:

21. Under ……………………..deduction is not allowed in respect of an interest, royalty, fees for technical services or other sum chargeable under the Income-tax Act.
22. Any interest, commission or brokerage, rent, royalty, fees for professional services or fees for technical services payable to a resident, or amounts payable to a contractor or sub-contractor for carrying out any work on which tax is deductible at source under ………………………….
23. Under Section 40(a)(ii), any sum paid by the assessee on account of any tax or rate levied on profits on the basis of or in proportion to the profits and gains of any business or profession, would be disallowed in ……………………….
24. Any wealth-tax paid or payable by the assessee in respect of his business assets would be………………………

9.7 Depreciation

In computing income from business, one of the most important items of allowances is the allowance for depreciation provided by Section 32 of the Income-tax Act. The deduction towards depreciation is very essential to arrive at the income of the assessee and also to amortise the capital cost of the amount invested in buildings, machinery, plant and furniture. The purpose of allowing depreciation is to provide in course of time for the replacement of asset with the help of the capital cost of the asset which is allowed to be amortised over a period of time. The provisions for allowing depreciation are contained in Section 32 and are regulated under Rule 5 of the Income tax Rules. The rates of depreciation are also provided in the Income-tax Rules.

9.7.1 Conditions for Allowing Depreciation

In order that the depreciation is allowable, the following conditions must be fulfilled:

1. ***Classification of Assets:*** The assets in respect of which depreciation is claimed must be buildings, machinery, plant or furniture. In addition to these tangible assets intangible assets like know how, patent rights, copy rights, trade marks, licences, franchises or any other business or commercial right of similar nature acquired on or after 1.4.1998 are eligible for depreciation.

Notes

These intangible assets will form a separate block of assets. As and when any capital expenditure is incurred by an assessee on acquiring such intangible assets, the amount of such expenditure will be added to the block of intangible assets and depreciation will be claimed on the written down value at the end of financial year.

While taking into account the depreciation allowance in respect of a building, only the cost of the building is to be taken into account but not the cost of the land on which the building is erected because the land does not suffer any depreciation as a result of wear and tear or its usage. Thus, the term building used in this context refers only to the super-structure and not the land on which it is erected. Roads within a factory compound form part of building which is used for the purpose of the business and as such are entitled to depreciation.

Similarly, residential quarters provided to the employees are used for the business in the sense that they are used for and such user is incidental to the carrying on the business. Therefore, the roads to such residential quarters are also entitled to depreciation at the rates applicable to first class building.

a. *Plant:* The term 'plant' for the purpose of allowance of depreciation has been defined in Section 43(3) to include ships, vehicles, books, scientific apparatus and surgical equipment used for the purposes of the business or profession. However, on the basis of cases decided by the courts, the following are also included in the term 'plant':

    - In the case of a hotel, pipe and sanitary fittings
    - In the case of electric supply company, mains service lines and switch gears
    - Well.
    - In the case of manufacturer of oxygen, gas-cylinder for storing gas.
    - Technical know-how in the form of blue prints, instruction, technical manuals.
    - Thermocol insulation.
    - New Coils.
    - Data Processing Machines.

Since the definition of plant is inclusive in nature, it should be taken to cover all goods and chattels, whether fixed or moveable which a businessman may keep for the purpose of employment in his business with some degree of certainty and duration of time.

Caution However, following are some of the instances which are not held as plant:

1. Warehouses for storage purposes
2. Horses
3. Human body
4. Bed of River
5. Water storage tanks used for storing water by the supplier for irrigation purposes.
6. Cinema Theatres
7. Hotel Building

Moreover, 'tea bushes', 'livestock', buildings or furniture and fittings have been excluded from the definition of plant w.e.f. assessment year 1962–63.

b. *Ownership vs lease:* Depreciation is allowable to the assessee only in respect of those capital assets which are owned by him. In case of a building, the assessee must be owner of the super-structure and not necessarily of the land on which it is constructed.

If the assessee is only a tenant of the building but not its owner he is not entitled for allowance in respect of depreciation thereof. Where the land on which the building is constructed has been taken on lease by the assessee, the allowance of depreciation would be admissible only if, according to the lease deed, the assessee is entitled to be the owner of the super-structure. The fact that as part of the terms of the lease deed, the building, after expiry of the lease is to be transferred to the lessor of the land would not affect the allowance for depreciation.

Notes In the case of assets acquired on hire-purchase e.g., plant and machinery taken on hire, the assessee would not be the owner thereof and consequently would not be entitled for depreciation in respect of the same. But if the plant and machinery had been acquired on instalment basis, the assessee becomes the owner of the assets the moment the purchase or sale is concluded and consequently is entitled to depreciation although a part or whole of the price is payable in future.

c. *Used for the purpose of Business or Profession:* The allowance for depreciation is subject to the condition that the assets on which depreciation is claimed are actually used by the assessee for the purposes of his business or profession during the accounting year.

The allowance for depreciation, however, is not subject to the condition that the asset in question must be used throughout the relevant accounting year in order to enable the assessee to claim depreciation.

Thus, even if the asset is used for a very small fraction of the accounting year, the assessee would be entitled to depreciation in respect of the full amount allowable as if the asset had been used throughout the accounting year. Even in the case of seasonal factories (e.g., sugar manufacturing companies), the full amount of depreciation is allowable if the asset had been used at any time during the accounting year in the factory.

In cases where the depreciable asset is used partly for business purposes and partly for other purposes, the deduction towards depreciation allowable under Section 32 would be of a sum proportionate to the depreciation allowance to which the assessee would have otherwise been entitled, in the year in which the depreciable asset is sold, destroyed, discarded or demolished, no depreciation at the rates prescribed in the Income-tax Rules would be allowable.

d. *Amount of deduction shall not exceed actual cost:* The total amount of all items of depreciation allowance allowed to the assessee from year to year shall not exceed the actual cost of the block of assets to the assessee No deduction on sold assets to the assessee.

e. *No depreciation* is allowable in respect of the depreciable asset if the asset concerned is sold, destroyed, discarded or demolished in the same year in which it was acquired.

f. In order to be entitled to allowance towards depreciation, the assessee must furnish the prescribed particulars contained in Annexure 'B' attached to the Form of the Return of Income-tax. Any failure on the part of the assessee to furnish fully and truly all material facts, including the particulars prescribed for this purpose, would entitle the income-tax authorities to refuse to allow deduction towards depreciation.

g. *The Finance Act, 1995* has deleted w.e.f. assessment year 1996–97 the provision pursuant to which one could write off the entire cost of plant and machinery in the very first previous year in which it was put to use provided its actual cost did not exceed ₹ 5,000, to prevent the widespread misuse of the concession.

h. *The Finance (No. 2) Act, 1996* has rationalised the depreciation provisions, inter alia as follows:

- In case of joint ownership of an asset, depreciation would be allowed to each of the owner in proportion to the contribution to the total cost of the asset; and
- In case of amalgamation during the course of a previous year, the amalgamating company and the amalgamated company shall share the depreciation in proportion to the number of days during which the assets remained under their respective ownership.
- Similarly, in case of demerger during the course of a previous year (w.e.f. 1.4.2000), the demerged company and the resulting company shall share the depreciation in proportion to the number of days during which the assets remained under their respective ownership.

9.7.2 Basis of Depreciation

As stated in the earlier section of this unit the depreciation is provided in respect of "Block of assets" which, as per Section 2(11): means a group of assets falling within a class of assets, being tangible assets such as buildings, machinery, plant or furniture and intangible assets, being know-how, patents, copyrights, trademarks, licences, Franchises or any other business or commercial rights of similar nature, in respect of which the same percentage of depreciation is prescribed.

Moreover depreciation is now allowed on the written down value of all types of assets. Again, no deduction shall be allowed under this clause in respect of any motor car manufactured outside India, where such motor car is acquired by the assessee after the 28th day of February, 1975, and is used otherwise than in a business of running it on hire for tourists or,

a. outside India in his business or profession in another country, and

b. in respect of any machinery or plant if the actual cost thereof is allowed as a deduction in one or more years under an agreement entered into by the Central Government under Section 42 of the Act.

For the purposes of depreciation, the following terms are important:

1. Actual Cost
2. Written Down Value
3. Classification of Depreciation

9.7.3 Classification of Depreciation

The classification of depreciation for computation of income from business and profession can be stated as under:

1. ***Normal Depreciation [Section 32(1) Rule 5]:*** Normal depreciation is calculated at the specified percentage on the written-down value of block of assets (including ocean going

ships). Further, where any new machinery or plant is installed during the previous year for the purposes of manufacture or production of any article or thing, and such article or thing (a) is manufactured or produced by using any technology or know-how developed in, or (b) is invented in, a laboratory owned or financed by the Government or owned by a public sector company or university or a duly recognised institution, then such plant or machinery shall be treated as part of block of assets qualifying for depreciation @ 50% of written down value subject to the fulfilment of the following conditions:

(a) the right to use such technology or know-how or to manufacture such article or thing has been acquired from the owner of the laboratory or from any person who has derived the right from such owner;

(b) the return furnished by the assessee for his income or the income of any other person for which he is assessable for any previous year in which the said machinery or plant is acquired is accompanied by a certificate from the prescribed authority (Secretary, Department of Scientific and Industrial Research, Government of India) to the effect that such technology or know-how is developed in, or the article or thing is invented in such laboratory; and

(c) the machinery or plant is not used for the purposes of business of manufacture or production of any article listed in the Eleventh Schedule (i.e. low priority articles).

Notes For the purposes of above:

"Laboratory financed by the Government" means a laboratory owned by anybody (including a society registered under the Societies Registration Act, 1860 (21 of 1860), and financed wholly or mainly by the Government;

"Public sector company" means any corporation established by or under any Central, State or Provincial Act or a Government company as defined in Section 617 of the Companies Act, 1956;

"University" means a University established or incorporated by or under a Central, State or Provincial Act and includes an institution declared under Section 3 of the University Grant Commission Act, 1956, to be a University for the purposes of that Act.

2. ***Depreciation on Straight Line Basis:*** In the case of Power Units [Section 2(1)(i)] (optional to power generating units) From the assessment year 1998–99, an undertaking engaged in generation or generation and distribution of power can claim depreciation on straight line basis on the actual cost of individual asset. But the aggregate depreciation cannot exceed the actual cost. Alternatively, such undertaking can claim depreciation, at its option, according to written down value method like any other assessee. The option for this purpose shall be exercised before the due date of furnishing return of income. Once this option is exercised, it shall be final and shall apply to all the subsequent years.

Did u know? **Terminal depreciation**

If any asset, on which depreciation is claimed on basis of SLM, is sold and the amount by which money payable together with scrap value, fall short of WDV of such asset, depreciation shall be allowed equal to such deficiency in the year of sale.

Notes

Balancing Charge Section 41(2)

If any asset, on which depreciation is claimed on basis of SLM, asset is sold and the amount, by which moneys payable together with scrap value, exceeds WDV of such asset, then the least of the following shall be taxable under the head PGBP.

- difference between the actual cost and WDV
- difference between aggregate of moneys payable and WDV

3. ***Additional Depreciation [Section 32(1)(iia)]:*** With effect from Assessment year 2006–07 existing clause (iia) has been substituted by new Clause (iia) to provide additional depreciation in certain circumstances. The additional depreciation shall be allowed @20% of the actual cost. The conditions and restrictions imposed by this provision are as under.

   Under this clause the additional depreciation is available to assessee engaged in the business of manufacture or production of any article or thing or engaged in the business of generation or generation and distribution of power at the rate of 20% of actual cost of eligible new machinery or plant (other than ships and aircrafts acquired and installed in a previous year). Additional depreciation shall not be allowed if (a) any machinery or plant which, before its installation by the assessee, was used either within or outside India by any other person; or (b) any machinery or plant installed in any office premises or any residential accommodation, including accommodation in the nature of a guest house; or (c) any office appliances or road transport vehicles; or (d) any machinery or plant, the whole of the actual cost of which is allowed as a deduction (whether by way of depreciation or otherwise) in computing the income chargeable under the head "Profits and gains of business or profession" of any one previous year.

9.7.4 Calculation of Written Down Value (WDV) of a Block of Asset

The WDV of an asset block can be computed in the following manner:

1. Find out the written down value on the first day of the previous year (WDV) relevant to the assessment year, of all those depreciable assets on which the depreciation is allowed at the same rate. All such assets are known as "block assets";
2. The increase in the WDV by the actual cost of any asset falling within that block, acquired during the previous year;
3. Reduce from the above, the moneys payable in respect of any asset falling within that block, which is sold or discarded or demolished or destroyed during that previous year together with the amount of the scrap value, if any, so that the amount of such reduction does not exceed the written down value as so increased; and
4. In the case of a slump sale, decrease by the actual cost of the asset falling within the block as reduced by the amount of depreciation that would have been allowable to the assessee for any assessment year, so that the amount of such decrease does not exceed the written down value.

It means if the net consideration of an asset out of the block is less than the balance under (ii), there would be no capital gain. If the net consideration of an asset is more than the balance under (ii) (the value of all assets in the block) the excess shall be deemed to be short term capital gain. If all the assets of the block are sold in the previous year and the net consideration is less than the balance under (ii), the loss shall be deemed to be short-term capital loss.

Where any capital asset is acquired by the assessee under a scheme for corporatisation of a recognised stock exchange in India, approved by the Securities and Exchange Board of India established under Section 3 of the Securities and Exchange Board of India, 1992 (15 of 1992), the actual cost of the asset shall be deemed to be the amount which would have been regarded as actual cost had there been no such corporatisation.

Example:

This may be easily followed by the following example:

Depreciable assets on 1.4.2011 on which the depreciation is available at the same rate of 25%.

Asset A	3, 00,000
Asset B	5, 00,000
Asset C	7, 00,000
Total	15, 00,000
Less: [Depreciation @ 25% of 15, 00,000]	(3, 75,000)
(i) Written down value on 1.4.2012 of block of assets	11, 25,000
Add: Cost of Asset purchased during 2012–13	6, 00,000
(ii) Balance	17, 25,000
Asset B sold during year 2012–13	(6, 75,000)
(iii) Balance	10, 50,000
Less: Depreciation for 2012–13 @ 25% of 10,50,000	(2, 62,500)
Written down value of all assets on 1.4.2013	7, 87,500

The third proviso to Section 32(1) provides that where an asset being commercial vehicle is, acquired by the assessee on or after the 1st day of October 1998 but before the 1st day of April, 1999 for the purposes of business or profession, the deduction in respect of such asset shall be allowed on such percentage on the written down value thereof as may be prescribed.

Commercial vehicles in this proviso means heavy good vehicle, heavy passenger motor vehicle, light motor vehicle, medium goods vehicle and medium passenger motor vehicle but does not include maxi-cab, motor-cab, tractor and road-roller (as per their meaning assigned in Section 2 of the Motor Vehicle Act, 1988).

The fifth proviso to Section 32(1) provides that in cases of succession in business or profession, in the case of amalgamation of companies or in the case of demerger of companies depreciation of plant and machinery, buildings and furniture in any previous year shall not exceed the depreciation calculated at the prescribed rate as if the succession, amalgamation or demerger had not taken place. It also seeks to allow the deduction to the predecessor and the successor or the amalgamating company and the amalgamated company or the demerged company and the resulting company in the same proportion as the number of days for which they used the asset in the business or profession.

Section 38(2) provides that where any building, machinery, plant or furniture is not exclusively used for the purposes of the business or profession, the deduction under Sections 30(a) & (c), 31(i) & (ii) and 32(1)(ii) shall be restricted to a fair proportionate part thereof as may be determined by the Assessing Officer. This section has not been amended to cover Section 32(1)(i) under which depreciation to electricity undertaking is allowed. Hence, the depreciation for electricity, undertakings claiming deduction under Section 32(1)(i) cannot be proportionately disallowed under Section 38.

Notes

1. *No depreciation* shall be charged on the block of asset in the following two situations:

   Situation1: Section 50(1) when Block of assets is not empty but it's written down value is nil at end of the previous year,

   Situation 2: Section 50(2) when Block of assets is empty at end of previous year.

2. *Depreciation* is chargeable in respect of an asset at 50% of Normal rate of depreciation applicable to the block to which such asset belongs if the following conditions are satisfied:

   Condition 1: asset is acquired during a previous year and it is put to use in same previous year and

   Condition 2: asset is put to use for less than 180 days in such year.

Task If a factory of an assessee is shifted to new site, the expenses of shifting the depreciable asset or its installation would form part of the actual cost?

Examples of Computation of Income from Business and profession are given below:

Example: Advise an assessee about the admissibility or otherwise of the claims, with regard to the following items, giving reasons:

1. Compensation paid to an employee for premature termination of his services.
2. Amount spent in a successful suit filed against another for infringing the assessee's trademark.
3. Penalty paid to customs authorities for importing prohibited goods which yielded a large margin of profits.
4. Travelling expenses of a director who went to Europe for negotiating the purchase of new heavy machinery which was eventually installed next year.
5. Cost of erecting a medical annexe to the factory for the emergency treatment of the employees.
6. Lump-sum consideration paid for acquiring know-how 6,00,000.
7. Loss of ₹ 1,000 which were snatched away from the khazanchee's possession while going to bank to deposit the amount.
8. Loss due to embezzlement by an employee.
9. Brokerage paid for raising loan for the business.
10. ₹ 1,000 spent in connection with installation of a new telephone connection.
11. Fees paid to lawyer for drafting the Deed of Agreement with an outsider relating to the setting-up the business.
12. Pension paid to the window and children of a deceased engineer of the factory voluntarily.
13. Interest paid for funds borrowed specifically for the acquisition of a capital asset.

Solution:

Notes

1. Assuming that the termination of the services of an employee was in the interest of the business, this item will be treated as an admissible expenditure.
2. It is admissible as the expenditure has been incurred to maintain an asset (viz., the trademark).
3. Penalty paid for illegal activities of the assessee are not to be allowed as expenditure under the Income Tax Act.
4. It is inadmissible as it is incurred for the acquisition of a new asset.
5. It is not an admissible expenditure, being of a capital nature. However, depreciation can be claimed u/s 32(1).
6. On the cost of know-how depreciation shall be allowed @ 25% on W.D.V. basis u/s 32(1).
7. This loss is admissible as it was part of his duty to carry cash for depositing it in bank and hence it is incidental to the business.
8. It is admissible as it has been sustained during the ordinary course of business.
9. Brokerage paid for raising a loan for the business is an admissible expenditure.
10. It is an admissible deduction under executive instruction.
11. It is not admissible as it is in the nature of capital expenditure, but 1/5th of it will be allowed under Section 35D for five successive previous years.
12. Pension paid to the widow and children of a deceased engineer is not allowed as deduction as it is not an obligatory expenditure in connection with the business.
13. Interest paid for funds borrowed specifically for the acquisition of a capital asset is allowable u/s 36(1)(iii) as it is incurred for the purpose of the business.

Example: From the following Profit and Loss Account of a Merchant for the year ending 31st March, 2013. Compute his income from business and his total income for assessment year 2013–14:

Profit and Loss Account

		₹			₹
To	Trade expenses	700	By	Gross Profit	35,200
To	Salary	2,500	By	Dividend from a	
To	Rent, Rates and Taxes	2,400		Cooperative Society	3,000
To	Income-tax	1,400	By	Income from Property	850
To	Discount and allowance	300	By	Interest from Government	
To	Household expenses	2,000		Securities (gross)	2,000
To	Life Insurance Premium	1,000			
To	Interest on Capital	500			
To	Interest on loan	700			
To	Advertisement	800			
To	Postage and Telegram	50			
To	Audit Fee	200			
To	Provision for gratuity	4,000			

To	Fire Insurance Premium	730	
To	Provision for bad debts	2,000	
To	Provision for Income-tax	1,800	
To	Depreciation	4,000	
To	Net Profit	15,970	
		41,050	41,050

Solution:

Calculation of Taxable Profits from Business

Net Profit			15,970
Add: Inadmissible items:			
1.	Income tax	1,400	
2.	Household Expenses	2,000	
3.	Life Insurance Premium	1,000	
4.	Interest on Capital	500	
5.	Provision for gratuity	4,000	
6.	Provision for bad debts	2,000	
7.	Provision for Income-tax	1,800	
		12,700	28,670
Less: Income to be shown separately:			
1.	Dividends from a cooperative society	3,000	
2.	Income from property	850	
3.	Interest from Government Securities	2,000	(5,850)
Taxable Profits from Business			22,820

Calculation of Income from house property:

Income from property	850
Less: 30% under Section 24	(255)
Income from house property	595

Calculation of Income from other sources:

Dividends from cooperative society	3,000
Interest from Government Securities	2,000
Income from other sources	5,000

Calculation of Gross Total Income:

Income from house property	595
Income from Business	22,820
Income from other sources	5,000
	28,415

Self Assessment

Notes

State whether the following statements are true or false:

25. In computing income from business, one of the most important items of allowances is the allowance for depreciation provided by Section 32 of the Income-tax Act.
26. The deduction towards depreciation is very essential to arrive at the income of the assessee and also to amortise the capital cost of the amount invested in buildings, machinery, plant and furniture.
27. 25 per cent depreciation is allowable in respect of the depreciable asset if the asset concerned is sold, destroyed, discarded or demolished in the same year in which it was acquired.
28. Normal depreciation is calculated at the specified percentage on the written-down value of block of assets.

Case Study

Income from Trading of Shares

In this case there is no dispute that trading in shares is not the business of the assessee as authorised by memorandum of association. It is also a fact that the assessee had dealt in futures and as well as traded in shares of other companies. Therefore, we have to see the applicability of the Explanation to section 73 of the Act to the share trading activities carried on by the assessee. As per Explanation to Section 73 where any part of business of the company an assessee whose gross total income is not consisted mainly of income which is chargeable under the heads "Interest on securities", "Income from house property". "Capital gains" and "Income from other sources", or a company the principal business of which is the business or banking or the granting of loans and advances, consists of the purchase and sale of shares of other companies, such company shall, for the purposes of section 73, be deemed to be carrying on a speculation business to the extent to winch the business consists of the purchase and sale of such shares. The provisions of Explanation to section 73 do not distinguish between the transaction of trading in shares on actual delivery or without delivery basis. Admittedly the assessee does not fall under any of the exceptions provided in the Explanation and hence, the purchase and sale of shares traded during the year under consideration is in nature of speculation business within the meaning of proviso to section 73 of IT Act, 1961.

Hon'ble Madhya Pradesh High Court in the case of Intermetal Trade Ltd. (supra) has held that the Explanation to section 73 does not apply to an investment company or a company whose principal business is banking or money lending. If the business of a company which does not fall within the excluded categories consists of purchase and sales of shares of other company, than such a company shall be deemed to carrying in speculation business for the purpose of section 73 to the extent to which the business consists of purchase and sale of shares.

Hon'ble Calcutta High in the ease of Arvind investments Ltd. (supra) has also held the similar view. In this case it has been held that the Explanation to section 73 applies to the case of the assessee whose entire business consisted of dealing in shares. A loss incurred by the assessee was a speculation loss.

In the case of Mysore Rolling Mills (supra) Hon'ble Karnataka High Court held that where shares have been purchased as an investor, the provisions of Explanation to section 73 could not be applied.

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Notes

From the decisions of Hon'ble Courts referred to above, it is clear that/where assessee is engaged in trading in share of other companies, the business carried on by the assessee will be in nature of speculative business and profit or loss arising there from will be the speculative profit/loss/ In the instant case, admittedly, the assessee's business is not excluded Horn applicability of provisions of Explanation to section 73. Therefore, the profit arising on sale of shares will be speculative profits and in our considered opinion, A.O. has rightly assessed the same as speculative business.

Now let us examine the contention of Id AR of the assessee about Board Circular no 201 which is Explanatory Notes explaining the insertion of Explanation to section 73. The Board under section 110 has power, inter alia, to tone down the rigour of law and ensure a fair enforcement to its provisions by issuing circulars in exercise of its powers conferred upon n under section i 19 which arc binding on the authorities in the administration of the Act. Under section 119 (2j(aj), however, the circulars as contemplated therein cannot be adverse to the assessee. The power is given for the purpose of just, proper and efficient management of work of assessment and in public interest. It is a beneficial power given to the Board for proper administration of fiscal law so that undue hardship may not be caused to the assessee and fiscal laws may be correctly applied. Hard cases which could be properly categorized as belonging to a class thus can be given benefit of relaxation of law by issuing circulars binding on the taxing authorities. The Ld. AK of the assessee has relied on various decisions wherein the circulars issued by the CBD'J haves been held to be binding on the A.O. The Explanatory Notes to the amendment brought to the statute are not circulars issued u/s Il9(2)(b) of the Act. Since, the Explanatory Notes are neither orders nor directions issued under the power conferred under the section 119. The decisions relied by the assessee cannot be applied to the facts of the assessee's case.

Hon'ble Delhi High Court in the case of Bhandari Company P. Ltd.(supra) has held that where language of statute is plain, the speech of Finance Minister. Notes of clauses and circulars issued by the Compam Law Board to the effect that deposits from directors and shareholders excluded from the definition of deposit could not be resorted for interpreting provisions.

Hon'ble. Supreme Court in the case of K.P. Varghese vs. 1TO, 131 1TR 597 has held that the speech made by the Members of Legislature during the course of debate on a Bill are inadmissible for interpreting the statutory provisions but me speech made by the mover of the Bill can be referred to for the purpose of ascertaining the mischief to be remedied by the legislation and the object arid the purpose for which the legislation is enacted. As to the marginal note to the section, their Lordships of Hon'ble Supreme Court have held they cannot be referred to for the purpose of construing the section but can be relied upon as indicating the drift of section or to show what die section is dealing with. As to the circulars issued be the CBDT, their Lordships have held that they are valuable evidence of contemporaneous exposition, but must give way where the language of statute is unambiguous.

Hon'ble Madras High Court in the case of Puthuthofam Ltd. (supra) has held that it well settled that the explanation given to the Members of Parliament either in the shape of Notes on Clauses or Memorandum explaining the provisions are not aids to the construction. The statute has to be construed on its own words and not on what the supposed intention behind it was except in the somewhat rare event of the provisions not yielding any meaning unless the intention is taken into account.

Hon'ble Bombay High Court in the case of Associated Cement Co. Ltd. (supra) has held that the memorandum explaining the provisions of the Finance Bill or the circular of Board cannot be used to curtain or modify the clear meaning of an expression used in the

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statute. Hon'ble Bombay High Court in the case of CIT vs. Central Bank of India Ltd. (bull Bench) supra has held that where there is no ambiguity in language used in the statute, the notes on clauses and memorandum explaining provisions cannot be referred to as aids in interpretation.

From the decisions of various courts referred to above it is clear that where the language of statute is clear, the notes on clauses and memorandum explaining the statutory provisions cannot he resorted to interpret the statutory provisions the language used in explanation to section 73 is plain, clear and unambiguous. Therefore, the memorandum explaining the provisions of amendment cannot be resorted to for the purpose of interpretation. As discussed above the explanatory notes are not circulars issued under section 119(2)(b) of the Act and. therefore, the decision relied upon by the Ld. Counsel for the assessee are distinguishable on facts The decision relied by the assessee in the case of vegetable products (supra) is also not applicable as there is no split of opinion on the applicability of the notes and clauses and memorandum explaining the statutory provisions. Rather Hon'ble Supreme Court as discussed above in the case of K.P. Varghese has held that explanatory notes cannot be used for interpreting the provisions of law. In view of above discussions, in our considered opinion Ld. CIT(A) was not justified in deleting the addition on the basis of Explanatory Notes, therefore. The income from trading of shares as observed above will be speculative business within the meaning of provision of explanation of section 73 of the Act. We, therefore, set the order of the CIT (A) and restore the order of the A.O.

Questions

1. Study and analyse the above case
2. Write down the case facts.
3. What do you infer from it?

Source: http://taxguru.in/income-tax-case-laws/income-from-trading-of-shares-will-be-speculative-business-within-meaning-of-provision-of-explanation-to-section-73.html

9.8 Summary

- The meaning of the expression 'Business' has been defined in Section 2(13) of the Income-tax Act. According to this definition, business includes any trade, commerce or manufacture or any adventure or concern in the nature of trade, commerce or manufacture.
- The expression 'Profession' has been defined in Section 2(36) of the Act to include any vocation. In the case of a profession, the definition given in the Act is very much inadequate since it does not clearly specify what activities constitute profession and what activities do not.
- Section 28, deals with the income is chargeable to tax under the head "Profits and gains of business or profession".
- Income under the heads "Profits and gains of business or profession" and "Income from other sources" shall be computed in accordance with method of accounting regularly employed by the assessee. There are two main methods of accounting—mercantile system and cash system.
- The term 'speculation' has not been exhaustively defined in the income-tax Act, but it normally denotes the meaning commonly assigned to it in commercial practice. However, Section 43(5) defines the expression "speculative transaction" as "a transaction in which a contract for the purchase or sale of any commodity including stocks and shares is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrips".

- The profits and gains of business or profession are computed in accordance with the provisions contained in Sections 30 to 43D. Sections 30 to 37 contain those deductions which are expressly allowed while computing profits of business or profession.
- Section 40 provides those expenses which are allowed on the basis of general commercial principles while computing profits of business or profession. It is necessary to know those principles before studying the deductions expressly allowed while computing profits of business or profession.
- Sections 30 to 37 cover expenses, which are expressly allowed as deduction while computing business income, sections 40, 40A and 43B cover expenses which are not deductible.
- In computing income from business, one of the most important items of allowances is the allowance for depreciation provided by Section 32 of the Income-tax Act. The deduction towards depreciation is very essential to arrive at the income of the assessee and also to amortise the capital cost of the amount invested in buildings, machinery, plant and furniture.

9.9 Keywords

Auditor: An official whose job it is to carefully check the accuracy of business records.

Building: It means the superstructure only and does not include site.

Business: It includes any trade, commerce or manufacture or any adventure or concern in the nature of trade, commerce or manufacture.

Cash System of Accounting: It is an accounting system in which a record is kept of actual receipts and actual payments of a particular year.

Mercantile System of Accounting: It is an accounting system in which net profit or loss is calculated after taking into consideration all income and expenditure of a particular accounting year irrespective of the fact whether income is not received or expenditure is not actually paid during the accounting period.

Plant: It includes ships, vehicle, books (including technical know-how report), scientific apparatus and surgical equipment used for the purpose of business or profession. It does not include tea bushes or livestock or buildings or furniture and fittings.

Profession: It involves the concept of an occupation requiring either intellectual skill or manual skill controlled and directed by the intellectual skill of the operator.

Scientific Research: It implies any activity for the extension of knowledge in the fields of natural or applied sciences including agriculture, animal husbandry or fisheries.

Speculative Transaction: It is transaction in which a contract for the purchase or sale of any commodity including stocks and shares is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrips.

9.10 Review Questions

1. Define the concepts of business and profession.
2. What do you understand by continuity of business and profession?
3. Distinguish between Mercantile system of accounting and cash system of accounting.
4. What is meant by 'block of assets'? Explain.

5. Discuss the items which are disallowed as deduction while computing firm's income from business and profession.
6. How will you compute income from Business or Profession?
7. Discuss depreciation concept in detail.
8. Mention the steps involved in computation of written down value of an asset block with the help of a suitable example.
9. From the following figures, you are required to ascertain the depreciation admissible in the Assessment year 2013–14:

Particulars	Machinery	Building
WDV as on 01-04-12	5, 00,000	20, 00,000
Additions during the year	6, 00,000	Nil
Sale during the year	12, 00,000	4, 00,000
Rate of depreciation	15%	10%

Answers: Self Assessment

1.	Section 2 (13)	2.	Profit
3.	Section 2 (36)	4.	Casual or non-recurring
5.	True	6.	True
7.	False	8.	True
9.	True	10.	True
11.	False	12.	False
13.	Sections 30 to 43 D	14.	Section 40
15.	Deductions	16.	Profits
17.	Section 30	18.	Section 31
19.	Building	20.	Scientific research
21.	Section 40 (a)(i)	22.	Chapter XVIIB
23.	Full	24.	Totally disallowed
25.	True	26.	True
27.	False	28.	True

9.11 Further Readings

Books

Aggarwal, K. *Direct Tax Planning and Management.* Atlantic Publications.

Ahuja, G. K. & Gupta, Ravi. *Systematic Approach to Income Tax.* Bharat Law House.

Lakhotia, R. N. *Income Tax Planning Handbook.* Vision Books.

Singhania, V. K. & Singhania, Kapil. *Direct Taxes Law & Practice.* Taxmann Publications.

Srinivas E. A. *Handbook of Corporate Tax Planning.* Tata McGraw Hill.

Online links

http://business.gov.in/taxation/profit_gains.php

http://commercehub.webs.com/documents/NCOME%20UNDER%20THE%20HEAD%20PROFITS%20AND%20GAINS%20FROM%2 0BUSINESS%20AND%20PROFESSION.pdf

http://www.du.ac.in/fileadmin/DU/Academics/course_material/TM_07.pdf

http://www.incometaxmanagement.com/Pages/Gross-Total-Income/Business-Profession/Profit-Gain-Business-Professions-Contents.html

http://www.slideshare.net/bhaviksheth/business-profession

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Unit 10: Tax Planning for Different Organisations

CONTENTS

Objectives

After studying this unit, you will be able to:

- Discuss the Decision regarding Forms of Organisations
- Describe the Tax Planning for Sole Proprietorship
- Explain the Tax Planning for Partnership
- Elucidate the Tax Planning for Company

Introduction

According to the organization form, the enterprise types include individual proprietorship enterprise, partnership enterprise and limited corporation which can be divided into limited liability company and joint stock limited partnership, and because the tax system regulates different tax burden levels for the enterprises with different organization forms, so the establishment costs and advantages of different organization forms are different, and the tax is one of factors we should consider when we select the organization form of the enterprise. Especially when the organization form of the enterprise has large influence to the production and management, the tax will be the important factor which we should consider, and investors can select the organization form of the enterprise to reduce the tax burden for the enterprise. So, before one can embark on a study of Tax Planning for Different Organisations, it is absolutely vital to understand the meaning of tax planning and the concept of various kinds of business organizations and the importance of tax planning in Sole Proprietorship, Partnership and Company. The purpose of this Unit is to enable the students to comprehend basic expressions. Therefore, all such basic terms are explained and suitable illustrations are provided to define their meaning and scope.

10.1 Decision Regarding Forms of Organisations

A business organization can be owned and organized in several forms. Each form of organization has its own merits and demerits. The ultimate choice of the form of business depends upon the balancing of the advantages and disadvantages of the various forms of business. The right choice of the form of the business is very crucial because it determines the power, control, risk and responsibility of the entrepreneur as well as the division of profits and losses. Being a long term commitment, the choice of the form of business should be made after considerable thought and deliberation.

The various forms of organization are established by state law. There are a wide variety of business organizations recognized by the states. In order for an organization to run smoothly, decisions must constantly be made. How those decisions are made is an important factor in the success of a decision.

Example: A popular form of organization is the Limited Liability Company (LLC). The LLC is a state designation. At the federal level, an LLC is taxed as a partnership. If the LLC so chooses, it can be taxed as a corporation at the federal level.

Notes **Limited Liability Company (LLC)**

The LLC is a relatively new type of hybrid business structure that is now permissible in most states. It is designed to provide limited liability features of a corporation and the tax efficiencies and operational flexibility of a partnership. Formation is more complex and formal than that of a general partnership. The owners are members, and the duration of the LLC is usually determined when the organization papers are filed. The time limit can be continued if desired by a vote of the members at the time of expiration. LLC's must not have more than two of the four characteristics that define corporations: Limited liability to the extent of assets; continuity of life; centralization of management; and free transferability of ownership interests.

10.1.1 Forms of Business Organisations

Tax is not levied at the corporate level; instead all profits are fully distributed to the shareholders, and reported & taxed on each shareholder's 1040. On a profitable business, this will increase each shareholder's taxable income, and possibly move them to a higher tax bracket.

The various forms of Business Organisations are as follows:

1. ***Sole Proprietors:*** A sole proprietorship is a one-man business. The owner is liable for all of the company's debts. Furthermore, the company's income is considered to be the owner's personal income and must be reported on the owner's individual income tax return. The advantage of this form of business organization is simplicity—no partnership agreements need to be signed, there are no corporate registration formalities to perform, and there is no need for corporate formalities, such as shareholder's meetings.

2. ***Partnerships:*** In a general partnership, the business is owned by two or more general partners. Each of the partners is liable for the debts of the business. Although the partnership must file a separate tax return, each general partner is required to report his pro rata share of the partnership's income on his individual income tax return. A partnership agreement is a practical necessity for this form of business organization.

Did u know? There are two types of partnership forms:

Limited Liability Partnership – at least one partner must have unlimited liability

Unlimited liability Partnership- all partners have unlimited liability.

A deed of partnership must be drafted which set out the terms and conditions of the partnership. Various types of partners are as follows:

- *Ordinary/General Partners:* Take an active part in the running of the business.
- *Sleeping Partners:* Invest in the business but do not take an active part in the business.
- *Limited Liability Partners:* Assets will not be lost if the business goes bankrupt.

3. ***Company:*** A company is meant an association of many persons who contribute money or money's worth to a common stock and employs it in some trade or business, and who share the profit and loss (as the case may be) arising there from. The common stock contributed is denoted in money and is the capital of the company. The persons who contribute it, or to whom it belongs, are members. The proportion of capital to which each member is entitled is his share. Shares are always transferable although the right to transfer them is often more or less restricted. The main essentials features of a company are as below:

- *Registration:* According to the Company Act, 1994, registration is compulsory for a company. And a company comes into effect as a company after its registration.
- *Voluntary association:* The members of the company must be associated with their free consent and according to the choices of their purposes.
- *Contractual capacity:* A shareholder of a company can come into a contract with company and can be an employee of the company.
- *Management:* The Company and its whole functions must be managed by the Board of Director as formatted as prescribed in the Company Act, 1994 and the Memorandum of Association of a company.
- *Capital:* Without capital a company cannot run its functions.
- *Perpetual succession:* The Company has a perpetual succession. Death or insolvency of the shareholders of a company cannot affect the existence of a company.

- *Registered office:* A company must have a registered office.
- *Seal:* A company must have a common seal to run its functions.
- *Limitation of liability:* The liabilities of a shareholder of a company are always limited.
- *Transferable share:* The shares of a company are always transferable.
- *Capacity to sue:* A company is capable to sue to any matter in any competent court.

10.1.2 Factors Involved in Selection of Organisation

One of the decision factors includes how profitable your business is, and how much of those profits you want distributed to you versus re-investing the profits back into the business. The choice of the form of business is governed by several interrelated and interdependent factors:

1. ***The nature of business is the most important factor:*** Businesses providing direct services like tailors, restaurants and professional services like doctors, lawyers are generally organised as proprietary concerns. While, businesses requiring pooling of skills and funds like accounting firms are better organised as partnerships. Manufacturing organisations of large size are more commonly set up as private and public companies.
2. ***Scale of operations:*** That is volume of business (large, medium, and small) and size of the market area (local, national, international) served is the key factors. Large scale enterprises catering to national and international markets can be organised more successfully as private or public companies. Small and medium scale firms are generally set up as partnerships and proprietorship. Similarly, where the area of operations is wide spread (national or international), company ownership is appropriate. But if the area of operations is confined to a particular locality, partnership or proprietorship will be a more suitable choice.
3. ***The degree of control desired by the owner(s):*** A person, who desires direct control of business, prefers proprietorship, because a company involves separation of ownership and management.
4. ***Amount of capital required for the establishment and operation of a business:*** A partnership may be converted into a company when it grows beyond the capacity and resources of a few persons.
5. The volume of risks and liabilities as well as the willingness of the owners to bear it is also an important consideration.
6. Comparative tax liability.

Self Assessment

Fill in the blanks:

1. Being a ………………term commitment, the choice of the form of business should be made after considerable thought and deliberation.
2. A ………………is a one-man business.
3. A …………………may be converted into a company when it grows beyond the capacity and resources of a few persons.
4. A ……………is meant an association of many persons who contribute money or money's worth to a common stock and employs it in some trade or business, and who share the profit and loss (as the case may be) arising there from.

Caselet

Involving Limited Liability Companies and Registered Limited Liability Partnerships

The plaintiff sued her employer for hostile work environment and related claims. The complaint inaccurately identified the employer as a partnership rather than an LLC. The LLC's lawyer contacted the plaintiff's lawyer informing her of the mistake and offering to accept service of an amended complaint. The complaint was not amended, and the court dismissed it. A year and half later, an amended complaint was filed. In the new complaint, the plaintiff misidentified the LLC as a corporation. Two months later, after limitations had run, the defendant moved to dismiss the complaint, and the plaintiff moved to amend. The trial court denied the motion to amend and granted the motion to dismiss. The plaintiff appealed, arguing the trial court abused its discretion in finding inexcusable neglect on the part of the plaintiff. The plaintiff's lawyer explained that her files had been moved to off-site storage during the time the plaintiff was deciding whether to pursue a second lawsuit, and she did not have access to the documents showing the defendant was an LLC. The court took issue with this argument, stating that the plaintiff's lawyer chose not to access her files and to use the Washington Secretary of State's web site instead. The court acknowledged that the information in the web site is confusing in that LLC information is contained in the corporations' database and refers to the "state of incorporation" and "date of incorporation." Under "category," the site indicated the defendant was a "limited liability regular." The plaintiff's lawyer assumed that LLC meant Limited Liability Corporation. The court stated that the plaintiff's lawyer had no justification for assuming that the defendant was a corporation given the notice she received in the first lawsuit, the information obtained in the database search, and the availability of the LLC statute. The court concluded the failure to name the defendant as an LLC was inexcusable neglect and that the trial court's dismissal of the suit and award of attorney's fees to the defendant was proper.

Source: http://apps.americanbar.org/buslaw/newsletter/0006/materials/llcllp.pdf

10.2 Tax Planning for Sole Proprietorship

The term 'sole' means single and 'proprietorship' means ownership. So, only one person is the owner of the business organisation. This means, that a form of business organization in which a single individual owns and manages the business, takes the profits and bears the losses, is known as sole proprietorship form of business organisation. A sole proprietorship is the simplest form of business ownership. A sole proprietorship has but one owner. That sole owner may engage in any form of legal business activity anytime and anywhere. Other than the various local and state business licenses that every business must purchase regardless of type of ownership, no legal formalities are required to start or operate the business. The owner is responsible for securing and investing the funds for the business. These funds may come from the owner's existing or borrowed financial resources.

The sole proprietorship is the oldest, simplest, and most common form of business entity. It is a business owned by a single individual. For tax and legal liability purpose, the owner and the business are one and the same. The proprietorship is not taxed as separate entity.

Caution The earnings of the business are taxed at the individual level, whether or not they are actually in cash. There is no vehicle for sheltering income.

For liability purposes, the individual and the business are also one and the same. Thus, legal claimants can pursue the personal property of the proprietor and not simply the assets used in the business.

Notes As a self-employed individual, one can have a number of income tax planning opportunities. Here are some which one may wish to consider:

1. *Shifting and Timing Income:* Shifting income to family members can be an important tax planning technique. If you run your own business, your ability to shift income to a family member who is in a lower marginal tax bracket can be a significant advantage. Your relative may benefit from the increased income and you may benefit by the decreased tax liability. It's also possible that the overall amount of federal income taxes paid by the two of you would be lower. But be aware that the IRS could question an unreasonable amount of compensation paid to a family member, considering the services actually provided by the family member.

   As a self-employed taxpayer, you also have greater control and flexibility on timing the receipt of your income. This means that you have more control when you pay tax on the income.

2. *Planning Retirement:* Establishing a retirement plan is another tax planning advantage for the self-employed. If you're self-employed and have no employees, a qualified retirement plan may allow you to place pre-tax dollars into a retirement account to grow tax deferred until withdrawal. If you have employees, your business may have to provide coverage for them as well. The type of retirement plan that your business should establish depends on your specific circumstances.

3. *Reviewing Employee Benefit Plans:* Aside from retirement plans, there are other employee benefit plans—such as cafeteria plans and medical benefit plans. Employee benefit plans play an important role in attracting and retaining employees. Sole proprietors may also derive certain limited benefits under these plans.

4. *Considering Business Expenses and Other Deductions:* Make sure your business is taking advantage of all of the deductions it's entitled to, including deductions for certain start up costs. For instance, you may be able to deduct a portion of the expenses for a business trip even when the trip is combined with vacation. Other key deductions that you should consider include the use of a home office, automobiles and business assets.

A sole proprietorship is an individual (or married couple) who owns a business which is not otherwise incorporated or organized as a separate legal entity (i.e., there is no partnership, limited liability company, corporation, etc.). Putting it differently, sole proprietorships are businesses where an individual conducts business and holds title to property in his or her name and is directly and personally liable for the obligations of the business. There is no corporate entity or other legal device employed to hold the business assets or ameliorate the liability of the owner for any debts or obligations of the business.

Despite the personal liability that comes with the sole proprietorship, this form can be preferable where the owner contemplates no complex financing and no co-owner relationships with other parties. In fact, there are 15 to 20 million sole proprietorships in the United States. This comprises over 80% of the businesses in the United States!

Maintenance costs are very low for the sole proprietorship. Apart from any "doing business as" filings necessary if the sole proprietorship is using a name different from that of its owner, no documentation is needed to organize a sole proprietorship and no special record-keeping or corporate formality is necessary. You would not even need an attorney to form this type of business entity. By hanging out a sign, you have opened up a sole proprietorship.

Unlike other forms of business entities, there are no specific statutes governing the creation and existence of sole proprietorships. Instead, basic rules of contract law, tort law, and property law will apply. In addition to these basic concepts, all regulatory restrictions applied to businesses generally will apply to the sole proprietorship (e.g., environmental laws, civil rights laws, etc.).

The existence of the sole proprietorship ends upon the death of the owner and the property of the business will be disposed of according to the terms of the owner's will. All assets of the sole proprietorship are owned by the owner as personal property. On the whole, if you are planning to have a business of any sophistication, you probably want to avoid this entity.

According to the IRS, you're self-employed if you carry on a trade or business as a sole proprietor, an independent contractor, a member of a partnership or if you're otherwise in business for yourself. You can be a full-time employee and still have self-employment income from a side job. To determine whether a particular income is self-employment income (rather than employee wages, for example), look at the source of your income and the extent of your involvement in the activity. If you're self-employed, understand the self-employment tax and be aware of the tax planning opportunities.

Caution The Internal Revenue Service (IRS) permits one exception to the "one sole owner" rule. If the spouse of a married sole proprietor works for the firm but is not classified as either a partner or an independent contractor, the business may still considered to be a sole proprietorship and forgo having to submit a partnership income tax return. Also, the sole proprietorship can avoid self-employment taxes.

One major area of concern for many self-employed individuals is the high cost of health insurance. Fortunately, some of your health-care related expenses may be tax deductible.

Example: You may be eligible for the self-employed health insurance deduction, which would enable you to deduct the cost of health insurance that you provide for yourself, your spouse and your dependents. This deduction is taken on the front of your federal Form 1040 (i.e., "above-the-line") when computing your adjusted gross income, so it's available whether you itemize or not.

Contributions you make to a health savings account (HSA) are also deductible "above-the-line." An HSA is a tax-exempt trust or custodial account you can establish in conjunction with a high-deductible health plan to set aside tax-free funds for health-care expenses.

Its main features are as follows:

- Ease of formation is its most important feature because it is not required to go through elaborate legal formalities. No agreement is to be made and registration of the firm is also not essential. However, the owner may be required to obtain a license specific to the line of business from the local administration.
- The capital required by the organisation is supplied wholly by the owner himself and he depends largely on his own savings and profits of his business.
- Owner has a complete control over all the aspects of his business and it is he who takes all the decisions though he may engage the services of a few others to carry out the day-to-day activities.

- Owner alone enjoys the benefits or profits of the business and he alone bears the losses.
- The firm has no legal existence separate from its owner.
- The liability of the proprietor is unlimited i.e. it extends beyond the capital invested in the firm.
- Lack of continuity i.e. the existence of a sole proprietorship business is dependent on the life of the proprietor and illness; death etc. of the owner brings an end to the business. The continuity of business operation is therefore uncertain.

10.2.1 Tax Aspects of a Proprietorship

When filing an income tax return, no legal distinction exists between a person as a sole proprietor and an individual person. The sole proprietor's personal income tax return (Form 1040) must include calculation of the proprietorship's income tax as well as any income or loss that the owner incurs from any additional entity, such as an employee, investor, or the like. The tax code treats the sole proprietorship and the owner as one and the same: income earned by the business is seen as income of the owner and must be reported on the owner's IRS Form 1040. Expenses of the business are also claimed by the owner as deductions against income on the owner's year-end tax return.

Another important point to remember about sole proprietorships is that sole proprietorships are taxed on all net income; there is no way for your small business to retain earnings without you being taxed on that money. So if you expect or want to use income from the business to grow (i.e., you are going to reinvest the profits back into the business), you may want to consider creating a C-corporation.

Computation of Tax Liability of the Individual

The tax liability of the Individual on its taxable income is computed in the following manner:

(i) Ascertain the 'total income' of the individual by aggregating incomes falling under following four heads:-

- ❖ Income from House Property, whether residential or commercial, let-out or self-occupied. However, house property used for purpose of individual's business does not fall under this head.
- ❖ Profits and Gains of Business or Profession.
- ❖ Capital Gains.
- ❖ Income from other sources including interest on securities, winnings from lotteries, races, puzzles, etc.

(ii) To the total income so obtained, 'current and brought forward losses' should be adjusted for set off in subsequent assessment years to arrive at the gross total Income. The total income so computed is the 'gross total income'.

(iii) From the gross total income, prescribed 'deductions' of the Income Tax Act, 1961 shall be made to get the 'net income'. Generally, all expenses incurred for business purposes are deductible from taxable income, given that the expenses must be wholly and exclusively incurred for business purposes and also that the expenses must be incurred/paid during the previous year and supported by relevant papers and records. But expenses of personal or of capital nature are not deductible. Capital expenditure is deductible only through depreciation or as the basis of property in determining capital gains/losses. But no deduction shall be allowed in respect of any expenditure incurred in relation to income which does not form part of total income.

(iv) Tax liability is computed on the 'net income' that is chargeable to tax. It is done either on accrual basis or on receipt basis (whichever is earlier). However if an income is taxed on accrual basis, it shall not be taxed on receipt basis.

(v) From the tax so computed, tax rebates or tax credit are deducted

Tax Rates for Individuals, HUF's, AOPs, BOIs for the A.Y.2012–13 is shown in Table 10.1:

Income Tax Slabs and Rates for AY 2014–15 (FY 2013–14) are as follows:

(a) *For Individual or HUF or AOP or BOI or Artificial Judicial Person:*

Table 10.1: Tax Slabs for Individual, HUF and Artificial Judicial Person

	Income Slabs	Income Tax Rate
i.	Where the total income does not exceed ₹ 2,00,000/-.	NIL
ii.	Where the total income exceeds ₹ 2,00,000/- but does not exceed ₹ 5,00,000/-.	10% of amount by which the total income exceeds ₹ 2,00,000/-. Less: Tax Credit - 10% of taxable income upto a maximum of ₹ 2,000/-.
iii.	Where the total income exceeds ₹ 5,00,000/- but does not exceed ₹ 10,00,000/-.	₹ 30,000/- + 20% of the amount by which the total income exceeds ₹ 5,00,000/-.
iv.	Where the total income exceeds ₹ 10,00,000/-.	₹ 130,000/- + 30% of the amount by which the total income exceeds ₹ 10,00,000/-.

Source: http://finotax.com/itax/itaxrates13.htm

Surcharge: 10% of the Income Tax, where total taxable income is more than ₹ 1 crore.

Education Cess: 3% of the total of Income Tax and Surcharge.

(b) *For Individual resident who is of the age of 60 years or more but below the age of 80 years at any time during the previous year*

Table 10.2: Tax Slabs for Individual Resident (Age 60 Years or More but below 80 Years)

	Income Slabs	Income Tax Rate
i.	Where the total income does not exceed ₹ 2,50,000/-.	NIL
ii.	Where the total income exceeds ₹ 2,50,000/- but does not exceed ₹ 5,00,000/-	10% of the amount by which the total income exceeds ₹ 2,50,000/-.
iii.	Where the total income exceeds ₹ 5,00,000/- but does not exceed ₹ 10,00,000/-	₹ 25,000/- + 20% of the amount by which the total income exceeds ₹ 5,00,000/-.
iv.	Where the total income exceeds ₹ 10,00,000/-	₹ 1,25,000/- + 30% of the amount by which the total income exceeds ₹ 10,00,000/-.

Surcharge: 10% of the Income Tax, where total taxable income is more than ₹ 1 crore.

Education Cess: 3% of the total of Income Tax and Surcharge.

(c) *Individual resident who is of the age of 80 years or more at any time during the previous year*

Table 10.3: Tax Slabs for Individual Resident (Age 80 Years or More)

	Income Slabs	Income Tax Rates
i.	Where the total income does not exceed ₹ 5,00,000/-.	NIL
ii.	Where the total income exceeds ₹ 5,00,000/- but does not exceed ₹ 10,00,000/-	20% of the amount by which the total income exceeds ₹ 5,00,000/-.
iii.	Where the total income exceeds ₹ 10,00,000/-	₹ 1,00,000/- + 30% of the amount by which the total income exceeds ₹ 10,00,000/-.

Surcharge: 10% of the Income Tax, where total taxable income is more than ₹ 1 crore.

Education Cess: 3% of the total of Income Tax and Surcharge.

(d) *For Co-operative Society*

Table 10.4: Tax Slabs for Co-operative Society

	Income Slabs	Income Tax Rates
i.	Where the total income does not exceed ₹ 10,000/-.	10% of the income.
ii.	Where the total income exceeds ₹ 10,000/- but does not exceed ₹ 20,000/-.	₹ 1,000/- + 20% of income in excess of ₹ 10,000/-.
iii.	Where the total income exceeds ₹ 20,000/-	₹ 3,000/- + 30% of the amount by which the total income exceeds ₹ 20,000/-.

Surcharge: 10% of the Income Tax, where total taxable income is more than ₹ 1 crore.

Education Cess: 3% of the total of Income Tax and Surcharge.

10.2.2 Advantages of Sole Proprietorship

Perhaps the greatest advantage of this form of business is its simplicity and low cost. You are not required to file with the government, nor are any legal charter required. The sole proprietorship form of business has other advantages:

- The owner or proprietor is in complete control of business decisions.
- The income generated through operations can be directed into the proprietor's pocket or reinvested as he or she sees fit.
- Profits flow directly to the proprietor's personal tax return; they are not subject to a second level of taxation. In others words, profits from the business will not be taxed at the business level.
- The business can be dissolved as easily and informally as it was begun.

These advantages account for the widespread adoption of the sole proprietorship in the India. Any person who wants to set up shop and begin dealing with customers can get right to it, in most cases without the intervention of government bureaucrats or lawyers.

10.2.3 Disadvantages of Sole Proprietorship

This legal form of organization, however, has disadvantages:

- The amount of capital available to the business is limited to the owner's personal funds and whatever funds can be borrowed. This disadvantages limits the potential size of the business, no matter how attractive or popular its product or service.
- Sole proprietors have unlimited liability for all debts and legal judgments incurred in the course of business. Thus, a product liability lawsuit by a customer will not be made against the business but rather against the owner.
- The business may not be able to attract high-calibre employees whose goals include a share of business ownership. Sharing the benefits of ownership, other than simple profit-sharing, would require a change in the legal form of the business.
- Some employee benefits, such as owner's life, disability, and medical insurance premiums, may not be deductible, or may be only partially deductible from taxable income.
- The entity has a limited life; it exists only as long as the owner is alive. Upon the owner's death, the assets of the business go to his or her estate.

Self Assessment

State whether the following statements are true or false:

5. Sole proprietorship is not owned by a single individual.
6. Maintenance costs are very high for the sole proprietorship.
7. Expenses of the business are also claimed by the owner as deductions against income on the owner's year-end tax return.
8. Sole proprietors have unlimited liability for all debts and legal judgments incurred in the course of business.

10.3 Tax Planning for Partnership

Partnership is the most common form of business organisation in India. Partnership firms are governed by the provisions of the Indian Partnership Act, 1932. The Act lays down the rules relating to formation of partnership, the rights and duties of partners and dissolution of partnership. It defines partnership as a "relationship between persons who have agreed to share the profits of business carried on by all or any of them acting for all". This definition gives three minimum requirements to constitute a partnership:-

- There must be an agreement entered into orally or in writing by the persons who desire to form a partnership.
- The object of the agreement must be to share the profits of business intended to be carried on by the partnership.
- The business must be carried on by all the partners or by any of them acting for all of them.

Under the Act, persons who have entered into partnership with one another are individually called as 'partners' and collectively as 'firm' and the name under which they run their business is called the 'firm name'.

Notes

A partnership is a common vehicle in India for carrying on business activities (particularly trading) on a small or medium scale. A profession is generally carried on through a partnership. There is no restriction on a company's participation in a partnership, but this is rate in practice. Under the general law a partnership is not a separate entity distinct from the partners, but for tax purposes a partnership is an entity. Partnership firm arises from a contract between two or more persons who contribute some tangible and some intangible assets together with an objective of earning profit there from which will be shared between them in predefined portion. Therefore-

1. The firm should be evidenced by an instrument [Section 184(1i)]
2. The individual shares of the partners in the asset of the firm and the profits (or losses) should be specified in the instrument [Section 184(1ii)]
3. A certified copy of the instrument of partnership shall a company the return of income of the previous year in respect of which assessment of the firm is first suit [Section 184(2)]
4. Whenever Changes takes place in the constitution of the firm due to death or resignation of the partner or in the profit sharing ratio of the existing partners, a certified copy of the revised instrument of partner shall be submitted along with return of income of the related year. Where a minor is admitted to the benefit of the firm and the shares of the partners are unequal, it is necessary to specify how the shares of loss of the minor will be borne by the major partner.

The provisions related to the taxation of partnership firms are included in Chapter XVI of the Income Tax Act, 1961.U/s 184(1) of the Act, with effect from April 1, 1993 a firm shall be assessed as a partnership firm (PFAS), if the given conditions are satisfied as follows:

- Partnership is evidenced by a partnership deed and a certified copy thereof, which is duly signed by all partners, and is filed along with the Return of Income (ROI).
- Individual shares (profit/loss) of all the partners are also specified in the instrument i.e. in the partnership deed.
- Whenever there is some change in the constitution of the firm, then the firm requires furnishing along with the ROI, the certified copy of the partnership deed that is duly signed by all the partners.
- A change in constitution of the firm has been defined under section 187 of the Act which includes admission of new partner(s), retirement of existing partner(s) as well as any change in the profit/loss-sharing-ratio and excludes dissolution of the firm in case of death of any of its partners.

10.3.1 Position of Firm under the Income-tax Act

Legally, a partnership firm does not have a separate entity from that of the partners constituting the firm as the partners are the owners of the firm. However, a firm is treated as a separate tax-entity under the Income-tax Act. Salient features of the assessment of a firm are as under:

1. A firm is treated as a separate tax entity.
2. While computing the income of the firm under the head 'Profits and gains of business or profession', besides the deductions which are allowed u/S 30 to 37, special deduction is allowed to the firm on account of remuneration to working partners and interest paid to the partners. However, it is subject to certain limits laid down u/S 40(b).
3. Share of profit which a partner receives from the firm (after deduction of remuneration and interest allowable) shall be fully exempt in the hands of the partner. However, only that part of the interest and remuneration which was allowed as a deduction to the firm

shall be taxable in the hands of the partners in their individual assessment under the head 'profits and gains of business or profession'.

4. The firm will be assessed as a firm provided conditions mentioned under section 184 are satisfied. In case these conditions are not satisfied in a particular assessment year, although the firm will be assessed as firm, but no deduction by way of payment of interest, salary, bonus, commission or remuneration, by whatever name called, made to the partner, shall be allowed in computing the income chargeable under the head "profits and gains of business or profession" and such interest, salary, bonus, commission or remuneration shall not be chargeable to income-tax in the hands of the partner.

10.3.2 Provisions Relating to Taxation of Partnership Firms

The partnership firm is taxed as a separate entity, with no distinction as registered and unregistered firms. A partnership firm is or required to submit a copy of the partnership deed in the first year of assessment and later on only if there is a change in the terms/constitution of partnership. In computing the total income of the firm, any salary bonus, commission or remuneration, to a partner, shall be deductible subject to certain restrictions Partnership firm is subjected to taxation under the Income Tax Act, 1961. It is the umbrella Act for all the matters relating to income tax and empowers the Central Board of Direct Taxes (CBDT) to formulate rules (The Income Tax Rules, 1962) for implementing the provisions of the Act. The CBDT is a part of Department of Revenue in the Ministry of Finance. It has been charged with all the matters relating to various direct taxes in India and is responsible for administration of direct tax laws through the Income Tax Department. The Income Tax Act is subjected to annual amendments by the Finance Act, which mentions the 'rates' of income tax and other taxes for the corresponding year.

Under the Income Tax Act, the Partnership firm is taxed as a separate entity, distinct from the partners. In the Act, there is no distinction between assessment of a registered and unregistered firms. However, the partnership must be evidenced by a partnership deed. The partnership deed is a blue print of the rights and liabilities of partners as to their capital, profit sharing ratio, drawings, interest on capital, commission, salary, etc., terms and conditions as to working, functioning and dissolution of the partnership business.

Under the Act, a partnership firm may be assessed either as a partnership firm or as an association of persons (AOP). If the firm satisfies the following conditions, it will be assessed as a partnership firm, otherwise it will be assessed as an AOP:

- The firm is evidenced by an instrument i.e. there is a written partnership deed.
- The individual shares of the partners are very clearly specified in the deed.
- A certified copy of partnership deed must accompany the return of income of the firm of the previous year in which the partnership was formed.
- If during a previous year, a change takes place in the constitution of the firm or in the profit sharing ratio of the partners, a certified copy of the revised partnership deed shall be submitted along with the return of income of the previous years in question.
- There should not be any failure on the part of the firm while attending to notices given by the Income Tax Officer for completion of the assessment of the firm.

It is more beneficial to be assessed as a partnership firm than as an AOP, since a partnership firm can claim the following additional deductions which the AOP cannot claim:

- Interest paid to partners, provided such interest is authorised by the partnership deed.

- Any salary, bonus, commission, or remuneration (by whatever name called) to a partner will be allowed as a deduction if it is paid to a working partner who is an individual. The remuneration paid to such a partner must be authorised by the partnership deed and the amount of remuneration must not exceed the given limits.

10.3.3 Income Tax Rates for Partnership Firm

Income Tax rates applicable on partnership firm are listed in Table. Basic rates were unchanged in last four years however effective rates were reduced after removal of surcharge from firm tax.

Table 10.5: Income Tax Rates for Partnership Firm

FIRM	2009-10	2010-11	2011-12	2012-13
Tax Rate	30%	30%	30%	30%
Surcharge e (if net income exceeds 1 Crore)	10%	-	-	-
Edu. Cess & SHE Cess	3%	3%	3%	3%

Source: http://www.itaxindia.org/2011/10/income-tax-rates-for-partnership-firm.html

10.3.4 Advantages of a Partnership

Following are the advantages of a partnership are:

- Partnerships are relatively easy to establish; however time should be invested in developing the partnership agreement.
- With more than one owner, the ability to raise funds may be increased.
- The profits from the business flow directly through to the partners' personal tax return.
- Prospective employees may be attracted to the business if given the incentive to become a partner.
- The business usually will benefit from partners who have complementary skills.

10.3.5 Disadvantages of a Partnership

Following are the disadvantages of a partnership:

- Partners are jointly and individually liable for the actions of the other partners.
- Profits must be shared with others.
- Since decisions are shared, disagreements can occur.
- Some employee benefits are not deductible from business income on tax returns.
- The partnership may have a limited life; it may end upon the withdrawal or death of a partner.

Self Assessment

Fill in the blanks:

9. Partnership firms are governed by the provisions of the…………………..
10. A ………………….is generally carried on through a partnership.

11. The partnership firm is taxed as a ……………..entity.
12. Under the Income Tax Act, a partnership firm may be assessed either as a partnership firm or as an………………….

10.4 Tax Planning for Company

Section 3(1) (i) of the Companies Act, 1956 defines a company as "a company formed and registered under this Act or an existing company". Section 3(1) (ii) of the act states that "an existing company means a company formed and registered under any of the previous companies laws". A company is a separate legal entity. As such, it is able to hold property in its own name, sue and be sued and function separately from its owners. Individuals contribute capital to a company and are known as shareholders. It is the shareholders in the company directors who in turn will appoint managers for the day to day running of the business.

Tax planning is relevant in cases of surviving an audit, capitalizing on company deductions and engaging a friendly tax regime to run a business. Planning of taxes should be done in an efficient manner so as not to jeopardize the business goals of expansion, profits and growth. Minimizing the tax liability can provide more funds for the company and it can especially be useful in case of small businesses in need of more money than established firms or organizations for expansion of their activities. This source of increased funds can be utilized for larger expenses as a form of investment or even as a source for working capital. Deferring taxes is often a most popular way of tax planning as it allows the company to use the money interest free and sometimes even earn interest on the money until the next time when taxes will be due. Some of the general issues covering tax planning are choice of accounting and inventory valuation methods, the timing of purchase of necessary equipment and selection of tax-favoured benefit plans and investments.

As we know that in corporate tax planning, companies formulate strategies that are significant in minimizing taxes. Some valuable ways to save include sponsoring a retirement plan, writing off company assets, claiming depreciation expense, taking deductions on business automobiles, office expenses, self-employment health insurance, and employer sponsored child care resources, and using a home office for the company. Business tax planning involves understanding what it means to be self-employed. A company owner needs to be aware of anything that might impact taxes paid. Self-employment tax, company expenses and deductions, business assets, charitable contributions, shifting income, and retirement planning are important considerations.

Self-employment tax is due from those who are receiving income as an independent contractor, sole proprietor, or anyone who is conducting business through selling services or products. Corporate tax planning provides some ways that a business owner can save on income taxes both short-term and long-term. Income received must be reported but deductions can reduce the amount that is actually owed. The deductions can vary depending upon the type of industry and what are considered legitimate deductions.

Some company owners shift income to a family member as a tax advantage. In order to do this a family member must be providing some benefit to the business and the amount should be in line with the type of compensation. Shifting income legitimately can lower a company into a lower tax bracket. Of course the shifting of income to a family member could raise their income bracket and this should be considered. This is a business tax planning venture that should benefit both parties and should be done ethically and reasonably. To shift a large amount of income to a family member just to avoid paying taxes would be unethical unless there were a legitimate reason such as payment for services.

A retirement plan is a tax advantage to a person who is self-employed. This can be done with or without employees. However, it would affect the type of plan that is embraced. A self-employed

Notes

person can place pre-tax dollars into a retirement account. Having employees mean providing for them the capability of doing the same. A company owner can also choose other employee benefit plans to attract employees. Corporate tax planning involves looking out for employees by offering retirement, cafeteria and medical benefit plans. Cafeteria plans allow employees to use a portion of pre-tax income for medical or child care expenses.

There are many deductions that a company can take advantage of including start up costs, business trip expenses, home office use, the use of automobiles, and other assets. The costs of health care expenses are often deductible especially for the owner and dependents. In addition, any contributions made to a health savings account are also deductible expenses. Business tax planning includes knowing what plans provide the greatest benefits and implementing those plans to not only provides benefits to the company but benefits to employees as well.

When starting up a company many of the initial expenses can be written off up to a certain dollar amount. Some of these may include personal property like furniture or office equipment. Other things that can be written off the first year of purchase include machinery, fixtures, storage facilities, and other personal property. Other considerations when starting up a business include travel, vehicle usage, home office, and uniforms. Corporate tax planning sources suggests making sure that write-offs are legitimate business expenses. When using a home office for company use only a percentage of expenses can be written off. Travel expense can only apply when the travel is for the company. Combining company business with personal business must be taken into consideration for any type of write-off to be legitimate.

There is a degree of burden that is felt from tax legislation by any and every owner. However, there are positive ways that a corporation can comply with obligations and find ways to develop a strong company otherwise. Business tax planning includes taking advantage of opportunities to provide relief when possible. A corporate planning attorney can provide some good advice on how to structure a company to be optimally successful while remaining compliant with considerations such as paying taxes. Information can be found on the Internet that can help prepare a new business owner with how to be compliant in every area when it comes to reporting income and deducting expenses.

Task You are an individual who wishes to know the most suitable form of organization among Sole Proprietorship, Partnership and Company. How would you deal with the following questions?

1. What is the most appropriate structure for me, should I become a company?
2. Should I employ my spouse or children or bring them in as partners?
3. I am a partnership, what about introducing a company as a partner? What are the benefits and downsides?

Charitable contributions are a great way for a company to save on taxes and help those in the community. Many non-profit organizations are set up to help those who are less fortunate within the community that they reside and some offer services to anyone who they can help no matter where they are located. There are limits on how much of a contribution that can be counted and the organization has to fit the guidelines used by the IRS to be considered a legitimate charitable organization. Some of the ones who usually do qualify are churches, educational companies, scientific or medical research institutions, those that provide true charitable services and organizations who help animals. There is more information on the Internet about organizations that truly qualify as charitable.

Self Assessment

State whether the following statements are true or false:

13. It is the shareholders in the company directors who in turn will appoint managers for the day to day running of the business.
14. Maximising the tax liability can provide more funds for the company and it can especially be useful in case of small businesses in need of more money than established firms or organizations for expansion of their activities.
15. A retirement plan is a tax advantage to a person who is self-employed.
16. A company owner needs to be aware of anything that might impact taxes paid.

Case Study

A Self-employed IT Consultant

Opes Wealth Trust met with Brian, a 41 year old self-employed IT Consultant earning 140,000 per annum. Brian is married to Emma and they have two children aged 7 and 4. They have a mortgage-free home. They have no Will in place. Opes Wealth Trust began the 'Financial Solutions Service' by firstly carrying out a detailed fact-finding exercise with Brian and Emma, followed by a comprehensive financial planning exercise.

We have detailed below some of the specific findings.

1. We have helped Brian and Emma identify their financial objectives and the level of lifestyle income they desire at their desired target date (when Brian is aged 60).
2. We outlined the capital fund required to meet this target.
3. We assessed their progress against this target based on their current asset base and the existing regular level of pension funding and savings/investing.
4. We outlined the additional regular funding that would be required to reach their financial target.
5. We outlined tax-efficient planning tools and how such structures can greatly enhance real returns.

We provided a detailed analysis of their investments and detailed the annual investment returns that would need to be achieved to reach their financial goals. We also provided an analysis of their stated tolerance to investment risk versus where their current assets actually are at present relative to this. We outlined the relevance of this to them, and the relationship between investment risk and reward.

Choosing the Right Business Structure

We outlined the drawbacks to operating as a sole trader and provided a comprehensive outline of the benefits to Brian of incorporating his business and operating as a company going forward.

Once we had quantified their monthly lifestyle income, which was 3,500 net per month, we showed Brian the advantages of the corporate structure in reducing his effective tax rate.

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Protection

A comprehensive analysis of their protection requirements was undertaken.

Brian is the primary income earner, and particularly with two young children, it is essential that his income is protected in the event of illness, disability or death. We put the appropriate level of protection in place for the appropriate term at the most competitive cost.

Estate Management

As Brian and Emma have no Will in place, we highlighted the serious implications that this can have on their estate and their children's welfare in the event of their untimely death.

We held a number of meetings with them discussing the sensitive issue of their final wishes and who they would like to perform certain roles e.g. the Executor, Trustee and Guardian.

We worked with Brian and Emma in devising a financial model that provided the Guardian to the children with access to funds on a regular basis and on a specific needs basis.

Personal Tax Planning

We provided Brian with a detailed breakdown of the level of tax he is currently paying and how we can reduce this significantly through tax planning and restructuring.

Outcome

As a result of the Opes Wealth Trust planning exercise, Brian and Emma now have a very focused and tax-efficient financial plan in place that is appropriate to their specific circumstances. We have helped Brian establish a new company from which he now provides his services. This new corporate structure will enable Brian to accumulate wealth much more efficiently going forward. They also have the peace of mind that comes with knowing that, in the unfortunate event of something happening either of them, they have a tax-efficient and up-to-date estate plan that deals with how their children are looked after and ensures that their final wishes for their estate are adhered to.

Benefits to operating in a company structure:

1. *Limited Liability:* This provides a safeguard for individuals against their personal assets.
2. *Tax Efficiency:* A company can be a very tax efficient structure, both for transacting business and also through creating wealth in a personal capacity for the directors and employees through retirement planning. One of the major benefits of incorporation is access to the lower tax rates that apply to a company's profits, as well as it being more economical to build up working capital in a company rather than as a sole trader.
3. *Corporate Identity:* A company is a separate entity with its own sense of image, stability, sophistication and credibility.
4. *Raising Equity/Capital:* A company provides individuals with the ability to raise equity by selling its own shares to potential investors. This is on top of traditional sources of finance such as loans which require interest to be paid.
5. *Continuous Life:* A company can survive its founders. It also provides some additional comfort in the area of permanence of the business activity.

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6. *Flexibility:* A company's shares can be transferred, pledged, sold, given away, used as security, or given as bonuses.
7. *Alignment of key individuals with success of the business:* A company can align key individuals to the longer term success of the business. Increasing salaries or paying bonuses can provide incentives for short term performance, whereas stock options align the individual in the longer term.
8. *Cash Extraction:* The process of incorporation itself, for an existing business, can be used as a tool to allow the sole trader to extract capital value from the business in a tax-efficient manner as a part of the transfer of the business to the new company.
9. *Succession Planning:* Generally speaking, a company will be a more attractive business prospect to either a potential purchaser in the future or to transferring ownership of the business to the children. Not only will the stamp duty cost be reduced with the company structure but the business owner may also be in a position to extract profits in a tax-efficient manner before the disposal, thus reducing the overall tax cost to both the seller and the purchaser.

Questions

1. Study and analyse the case.
2. Write down the case facts.
3. What do you infer from it?

Source: Adapted from http://www.opeswealthtrust.ie/self-employedprofessionals/case-study-2-a-self-employed-it-consultant-for-whom-we-recommended-that-he-incorporate-his-business/

10.5 Summary

- A business organization can be owned and organized in several forms - Sole Proprietorship, Partnership and Company.
- The various forms of organization are established by state law.
- A sole proprietorship is a one-man business.
- In a general partnership, the business is owned by two or more general partners.
- A company is meant an association of many persons who contribute money or money's worth to a common stock and employs it in some trade or business, and who share the profit and loss (as the case may be) arising there from.
- The sole proprietor's personal income tax return (Form 1040) must include calculation of the proprietorship's income tax as well as any income or loss that the owner incurs from any additional entity, such as an employee, investor, or the like.
- A firm is treated as a separate tax-entity under the Income-tax Act.
- The partnership firm is taxed as a separate entity, with no distinction as registered and unregistered firms.
- Planning of taxes should be done in an efficient manner so as not to jeopardize the business goals of expansion, profits and growth.
- A company owner needs to be aware of anything that might impact taxes paid and for this Self-employment tax, company expenses and deductions, business assets; charitable contributions, shifting income, and retirement planning are important considerations.

10.6 Keywords

Company: A voluntary association formed and organized to carry on a business.

Limited Liability Partners: He is a kind of partner whose assets will not be lost if the business goes bankrupt.

Limited Liability Partnership: A limited liability partnership (LLP) is a partnership in which some or all partners (depending on the jurisdiction) have limited liability.

Ordinary/General Partners: He is a kind of partner who takes an active part in the running of the business.

Organisation: An organisation is a social entity that has a collective goal and is linked to an external environment.

Partnerships: A partnership is a strategic alliance or relationship between two or more people.

Sleeping Partners: He is a kind of partner who invests in the business but do not take an active part in the business.

Sole Proprietors: A business structure in which an individual and his/her company are considered a single entity for tax and liability purposes.

Tax Liability: The total amount of tax that an entity is legally obligated to pay to an authority as the result of the occurrence of a taxable event.

Tax Planning: Tax planning is the processes used by people and businesses to pay taxes.

10.7 Review Questions

1. Define Business Organisation.
2. Discuss the various forms of Business Organisations.
3. Highlight the factors involved in selection of organisation.
4. What is sole proprietorship? Elucidate its features.
5. Describe the Tax Aspects of a Proprietorship.
6. Throw some light on the advantages and disadvantages of sole proprietorship.
7. What is the position of firm under the income-tax act?
8. Elucidate the provisions relating to taxation of partnership firms.
9. Discuss the advantages and disadvantages of partnership.
10. "Planning of taxes should be done in an efficient manner so as not to jeopardize the business goals of expansion, profits and growth." Explain.

Answers: Self Assessment

1. Long
2. Sole Proprietorship
3. Partnership
4. Company
5. False
6. False
7. True
8. True

9. Indian Partnership Act, 1932
10. Profession
11. Separate
12. Association of Persons (AOP)
13. True
14. False
15. True
16. True

10.8 Further Readings

Books

Aggarwal, K. *Direct Tax Planning and Management.* Atlantic Publications.

Ahuja, G. K. & Gupta, Ravi. *Systematic Approach to Income Tax.* Bharat Law House.

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Online links

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http://business.gov.in/taxation/partnership_provisions.php

http://taxguru.in/finance/sole-proprietorship-in-india-meaning-advantage-disadvantage-necessity.html

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Unit 11: Computation of Taxable Income of Companies

CONTENTS

Objectives

After studying this unit, you will be able to:

- Discuss the computation of taxable income of Companies
- Explain the concept of Minimum Alternative Tax (MAT)
- Elucidate the Procedure for Computation of MAT under Section 115JB
- Describe the treatment of tax on distributed profits of Domestic Company
- Access the tax on dividend and income received from Venture Capital Companies

Introduction

Taxable income refers to the amount of income that is used to calculate an individual's or a company's income tax due. Taxable income is generally described as gross income or adjusted gross income minus any deductions, exemptions or other adjustments that are allowable in that tax year. Taxable income is also generated from appreciated assets that have been sold or capitalized during the year and from dividends and interest income. Income from these sources is generally taxed at a different rate and calculated separately by the tax entity.

Company whether Indian or foreign is liable to taxation, under the Income Tax Act, 1961. Corporation tax is a tax which is levied on the incomes of registered companies and corporation. However, for the purpose of taxation, companies are broadly classified as *domestic company* which is a company formed and registered under the Companies Act, 1956 or any other company which, in respect of its income liable to tax, under the Income Tax Act, has made the prescribed arrangement for declaration and payments within India, of the dividends payable out of such income. A domestic company may be a public company or a private company and a *foreign company* which is a company whose control and management are situated wholly outside India, and which has not made the prescribed arrangements for declaration and payment of dividends within India.

In this unit we will study the computation of taxable incomes for companies by taking into consideration the concepts of MAT, tax on distributed profits of Indian companies and tax on dividends and income by VCC etc.

11.1 Computation of Taxable Income of Companies – An Overview

Indian companies are taxable in India on their worldwide income, irrespective of its source and origin. Foreign companies are taxed only on income which arises from operations carried out in India or, in certain cases, on income which is deemed to have arisen in India. The later includes royalty, fees for technical services, interest, gains from sale of capital assets situated in India (including gains from sale of shares in an Indian company) and dividends from Indian companies. Thus, the tax-liability on income of a company depends upon the residential status of the company.

Residential Status of a Company

A Company is said to be resident in India during any relevant previous year if:

i. It is an Indian Company; or

ii. The control and management of its affairs is situated wholly in India. In case of Resident Companies, the total income liable to tax includes (section 5(1)):

   - Any income which is received or is deemed to be received in India in the relevant previous year by or on behalf of such company
   - Any income which accrues or arises or is deemed to accrue or arise in India during the relevant previous year
   - Any income which accrues or arises outside India during the relevant previous year.

Similarly, a Company is said to be non-resident during any relevant previous year if:

i. It is not an Indian company, and

ii. The control and management of its affairs is situated wholly or partially outside India. In case of Non-Resident Companies, the total income liable to tax includes (section 5(2)):

   - Any income which is received or is deemed to be received in India during the relevant previous year by or on behalf of such company
   - Any income which accrues or arises or is deemed to accrue or arise to it in India during the relevant previous year.

As a result a situation may arise where the same income becomes taxable in the hands of the same company in one or more countries, leading to 'Double Taxation'. The problem of double taxation may arise on account of any of the following reasons:

- A company (or a person) may be resident of one country but may derive income from other country as well, thus he becomes taxable in both the countries.
- A company or person may be subjected to tax on his world income in two or more countries, which is known as concurrent full liability to tax. One country may tax on the basis of nationality of tax-payer and another on the basis of his residence within its border. Thus, a person domiciled in one country and residing in another may become liable to tax in both the countries in respect of his world income.

- A company or person who is non-resident in both the countries may be subjected to tax in each one of them on income derived from one of them, for example, a non-resident person has a Permanent establishment in one country and through it he derives income from the other country.

Did u know? For companies, income is taxed at a flat rate of 30% for Indian companies, with a 5% surcharge applied on the tax paid by companies with gross turnover over 1 crore (10 million).

Foreign companies pay at the income tax at the rate of 40% plus 2% surcharge on the income tax payable. An education cess of 3% on both the tax and the surcharge are payable, yielding effective tax rates of 32.5% for domestic companies and 41.2% for foreign companies. From 2005–06, electronic filing of company returns is mandatory.

11.1.1 Taxable Income of Companies

The main source of income of a company is generally from "business". A company would also earn income from under the following heads:

a. Income from house property

b. Income from capital gains

c. Income from other sources

Taxable income is calculated according to the rules for each class of income and then aggregated to determine total taxable income.

Deductibility of Expense

While calculating income from business or profession, expense incurred wholly and exclusively for business purposes are generally deductible. These include depreciation on fixed assets, interest paid on borrowings in the financial year etc.

Certain expenses are specifically disallowed or the amount of deduction is restricted. These expenses include:

- Entertainment expenses
- Interest or other amounts paid to a non-resident without deducting without tax
- Corporate taxes paid
- Indirect general and administrative costs of a foreign head office.

Set-off and Carry Forward of Losses

Business losses incurred in a tax year can be set off against any other income earned during that year, except capital gains. Unabsorbed business losses can be carried forward and set off against business profits of subsequent years for a period of eight years; the unabsorbed depreciation element in the loss can however, be carried forward indefinitely. However, this carry forward benefit is not available to closely-held (private) companies in which there has been no continuity of business or shareholding pattern. Also, any change in beneficial interest in the shares of the company exceeding 51 per cent disqualifies the private company from the carry forward benefit.

Tax Rates for Companies

Notes

The corporate tax rate in India is at par with the tax rates of the other nations worldwide. As mentioned above the corporate tax rate in India depends entirely on the origin of a company. In India the corporate tax rates differ with regards to the nature of the ownership of the company and their income.

1. *Tax rates for Domestic Corporate & LLP Income Taxes Rates*

Table 11.1: Domestic Corporate and LLP Tax Rates

Company Type	Tax Rate	Effective Tax Rate with surcharge & Education cess
Domestic Corporations or Private Limited Companies	30%	33.99%*
Domestic Corporations or Public Limited Companies	30%	33.99%*
Limited Liability Partnership (LLP's)	30%	30.9%**

* For the above tax rates a surcharge of 10% of the income tax is levied, if the taxable income exceeds ₹ 1 million. Educational cess is also added.

** An Educational Cess is added to the basic tax rates. Surcharge is not applicable to LLP. Unlike LLP's in the USA where they are pass-through entities for tax purposes, in case of LLP's in India, they are partially pass-through entities for tax purposes. In India tax an LLP is required to pay income tax on 40% of its income; since an LLP is allowed to pay the balance of 60% as remunerations to it partners. Partners of an LLP are required to pay tax on the amount paid to them. Besides, LLP's are not required to pay dividend distribution tax or Minimum Alternate Tax (MAT).

2. ***All companies incorporated in India are deemed as domestic Indian companies for tax purposes, even if owned by foreign companies.***

Table 11.2: Foreign Corporate Income Tax Rates

Type of Income	Withholding Tax Rate for non-treaty foreign companies	Withholding Tax Rates for the USA Companies Doing Business in India under the India USA Tax Treaty
Dividends	20%	15%*
Interest Income	20%	15%**
Royalties	30%	20%**
Technical Services	30%	20%**
Other income	55%	55%

* Inter-corporate rates where there is minimum holding. The tax rates are applicable under the India USA Tax Treaty. For other countries the tax rates are different under the tax treaties between India and other countries, including Australia, Austria, Bangladesh, Belgium, Brazil, Belarus, Bulgaria, Canada, China, Cyprus, Czechoslovakia, Denmark, Finland, France, Germany, Greece, Hungary, Indonesia, Israel, Italy, Japan, Jordan, Kazakhstan, Kenya, Libya, Malta, Malaysia, Mauritius, Mongolia, Namibia, Nepal, Netherlands, New Zealand, Norway, Oman, Philippines, Poland , Qatar , Romania, Singapore, South Africa , South Korea , Spain , Sri Lanka , Sweden, Switzerland, Syria, Tanzania, Thailand, Trinidad & Tobago, Turkmenistan, Turkey , U.A.E. , U.A.R., U.K., U.S.A., Russian Federation, Uzbekistan, Vietnam and Zambia

** 10% or 15% in some cases.

In addition following should be noted:

a. Withholding tax is charged on estimated income, as approved by the tax authorities.

b. There are other favourable tax rates under various tax treaties between India and other countries.

Therefore in crux for companies, income is taxed at a flat rate of 30% for Indian companies. Foreign companies pay 40%. An education cess of 3% (on the tax) is payable, yielding effective tax rates of 33.99% for domestic companies and 41.2% for foreign companies. From the tax year 2005–06, electronic filing of company returns is mandatory.

Fringe Benefit Tax by Companies

Fringe Benefit Tax is a tax payable by companies against benefits that are seen by employees but cannot be attributed to them individually. This tax is paid as 33.99% of the benefit, which is only a percentage of the actual amount paid. Some fringe benefits and their taxable rates are mentioned:

Table 11.3: Fringe Benefit Tax Rates

Fringe Benefit	Taxable Percentage	Effective Tax Rate
Medical reimbursements	20%	6.8%
Telephone bills	20%	6.8%
Employee Stock Options (Difference between market value and purchase price on vesting date)	100%	33.99%

Source: http://www.madaan.com/taxrates.htm

Caution From April 1, 2007, Employees Stock Option Plan (ESOP) or Sweat Equity has also been brought within ambit of fringe benefit tax. Section 115WB(1)(d) specifies that any ESOP will attract Fringe Benefit Tax, and the benefit is equal to the difference between the price paid and the fair market value of the share, as determined by the Board. Tax is levied on the date of vesting of such options. "Fair Market Value" is not yet defined by the Income Tax Department.

Important Corporate Tax Rates in India

Following are some other important taxes which are applicable for the business entities in addition to the corporate taxes:

1. ***Fringe Benefit Tax (FBT):*** The Finance Act, 2005 had introduced a new levy, namely Fringe Benefit Tax (FBT). The provisions relating to levy of this tax are contained in Chapter XIIH (Sections 115W to 115WL) of the income-tax Act, 1961. Fringe Benefit Tax (FBT) is an additional income tax payable by the employers on value of fringe benefits provided or deemed to have been provided to the employees.

Notes The FBT is payable by an employer who is a company; a firm; an association of persons excluding trusts or a body of individuals; a local authority; a sole trader, or an artificial juridical person. This tax is payable even where employer does not otherwise have taxable income. Fringe Benefits are defined as any privilege, service; facility or amenity directly or indirectly provided by an employer to his employees (including former employees) by reason of their employment and includes expenses or payments on certain specified heads.

The benefit does not have to be provided directly in order to attract FBT. It may still be applied if the benefit is provided by a third party or an associate of employer or by under an agreement with the employer. The value of fringe benefits is computed as per provisions under Section 115WC. FBT is payable at prescribed percentage on the taxable value of fringe benefits. Besides, surcharge in case of both domestic and foreign companies shall be liveable on the amount of FBT. On these amounts, education cess shall also be payable.

2. *Minimum Alternative Tax (MAT):* A company is liable to pay tax on the income computed according to the provisions of the Income Tax Act, but the profit and loss account of the company is prepared as per provisions of the Companies Act. Under MAT, wherever the income tax payable on the total income of a company, in respect of any previous year, is less than the 'prescribed percentage of its book profits', such book profit shall be deemed to be the total income of the company and the tax payable on such total income shall be at the 'prescribed percentage of book profits', plus surcharge and education cess. The MAT is discussed in detail in the later section of this unit.

3. *Dividend Distribution Tax (DDT) or Tax on Distributed Profits of Domestic Companies:* Under Section 115-O of the Income Tax Act, any amount declared, distributed or paid by a domestic company by way of dividend shall be chargeable to dividend tax. Only a domestic company (not a foreign company) is liable for the tax. Tax on distributed profit is in addition to income tax chargeable in respect of total income. It is applicable whether the dividend is interim or otherwise. Also, it is applicable whether such dividend is paid out of current profits or accumulated profits.

   The tax shall be deposited within 14 days from the date of declaration, distribution or payment of dividend, whichever is earliest. Failing to this deposition will require payment of stipulated interest for every month of delay under Section115-P of the Act.

4. *Wealth Tax on Companies:* Wealth tax is a direct tax, which is charged on the 'net wealth' of the 'assessee' under the Wealth Tax Act. All companies (public or private) are liable to wealth-tax if their taxable 'net wealth' exceeds the prescribed limits. All the companies have thus been brought at par with other wealth-tax assesses.

   Net wealth of a company is the excess of the 'aggregate value of specified assets' belonging to the company on the valuation date over the 'aggregate value of debts owned by the company' that are incurred in relation to the said assets.

11.1.2 Steps in Computation of Taxable Income of Companies

In order to compute the taxable income of a Company the following steps are to be used:

Step 1: Ascertain the 'total income' of the company by aggregating incomes falling under following four heads:

a. Income from House Property, whether residential or commercial, let-out or self-occupied. However, house property used for purpose of company's business does not fall under this head.

b. Profits and Gains of Business or Profession.

c. Capital Gains.

d. Income from other sources including interest on securities, winnings from lotteries, races, puzzles, etc.

Also, income of other persons may be included in the income of the company. But, income under the head 'Salary' is not included under company. To the total income so obtained, 'current and brought forward losses' should be adjusted for set off in subsequent assessment years to arrive at the gross total Income. Thus the total income so computed is the 'gross total income'. The 'set off ' means, adjustment of certain losses against the incomes under other sources or heads as

Notes

prescribed in Section 79. This section applies to all losses including losses under the head 'Capital Gains'.

Unabsorbed depreciation may be carried-forward for set-off indefinitely. But carry back of losses or depreciation is not permitted. However, business losses can be carried forward for eight consecutive financial years and can be set off against the profits of subsequent years.

Step 2: From the gross total income, prescribed 'deductions' under Chapter VI A are made to get the 'net income'. Generally, all expenses incurred for business purposes are deductible from taxable income; given that the expenses must be wholly and exclusively incurred for business purposes and also that the expenses must be incurred or paid during the previous year and supported by relevant papers and records. But expenses of personal or of capital nature are not deductible.

Capital expenditure is deductible only through depreciation or as the basis of property in determining capital gains or losses. Deductions shall also be allowed in respect of depreciation, as per Section 32 of Income Tax Act, of tangible assets such as machinery, buildings, etc. and non-tangible assets such as know-how, patents, etc., which are owned by assessee and used for the purpose of business profession. Depreciation is deducted from the written-down value of the block of assets mentioned under Section 43 of the Act. However, where an asset is acquired by assessee during the previous year and is put to use for business or profession purpose for a period of less than 180 days, the deduction in respect of such assets shall be restricted to 50% of the normal value prescribed for all block of assets.

But no deduction shall be allowed in respect of any expenditure incurred in relation to income which does not form part of total income.

Step 3: Tax liability is computed on the 'net income' that is chargeable to tax. It is done either on accrual basis or on receipt basis (whichever is earlier). However if an income is taxed on accrual basis, it shall not be taxed on receipt basis. From the tax so computed, tax rebates or tax credit are deducted.

Calculating Companies Taxable Income

The key role played by any tax accountant is to calculate a company's taxable income. The taxable income of a company can be calculated using the following formula:

Taxable income = Assessable income – Allowable deductions

This formula applies to all entities, whether they are people known as real entities, or companies, partnerships and trusts all referred to as artificial entities. We use a company here for simplicity as companies are by far the most common of the artificial entities for which taxable income calculations are carried out in practice. We also use the company because they typically have accounting records from which the operating profit can readily be determined.

The taxable income calculation is quite simple. It is as follows:

Taxable income = Operating profit (+ or –) permanent differences + timing additions – timing subtractions (+ or –) future timing differences

Where:

- *Operating profit* = revenue – expenses.
- *Permanent differences* = accounting revenue items which are not income for tax law purposes OR accounting expenses which are not deductions for tax law purposes. Some common examples include entertainment or non-assessable dividends. Many of these items are listed in Division 26 of the 1997 Income Tax Act.

Notes

- *Timing additions* = accounting expenses which are not yet tax deductible. Some common examples include provisions for doubtful debts and annual leave.
- *Timing subtractions* = accounting revenue items which are not yet assessable income like revenue in advance, or accounting assets which are immediately deductible for tax law purposes.
- *Future timing differences* = accounting expenses which must be deducted over a prescribed time period in accordance with the tax law like borrowing costs.

Did u know? The classical system of corporate taxation is followed in India which encompasses the following:

1. Domestic companies are permitted to deduct dividends received from other domestic companies in certain cases.
2. Inter Company transactions are honoured if negotiated at arm's length.
3. Special provisions apply to venture funds and venture capital companies.
4. Long-term capital gains have lower tax incidence.
5. There is no concept of thin capitalization.
6. Liberal deductions are allowed for exports and the setting up on new industrial undertakings under certain circumstances.
7. There are liberal deductions for setting up enterprises engaged in developing, maintaining and operating new infrastructure facilities and power-generating units.
8. Business losses can be carried forward for eight years, and unabsorbed depreciation can be carried indefinitely. No carry back is allowed.
9. Specula tax provisions apply to activities carried on by non-residents.
10. A Minimum Alternative Tax (MAT) on corporations has been proposed by the Finance Bill 1996.
11. Dividends, interest and long-term capital gain income earned by an infrastructure fund or company from investments in shares or long-term finance in enterprises carrying on the business of developing, monitoring and operating specified infrastructure facilities or in units of mutual funds involved with the infrastructure of power sector are proposed to be tax exempt.

Self Assessment

Fill in the blanks:

1. Indian companies are taxable in India on their worldwide income, irrespective of its………………
2. While calculating income from business or profession, expense incurred wholly and exclusively for business purposes are generally …………….
3. …………………incurred in a tax year can be set off against any other income earned during that year, except capital gains.
4. For companies, income is taxed at a flat rate of …………………for Indian companies.

5. …………………is a tax payable by companies against benefits that is seen by employees but cannot be attributed to them individually.

6. ………………is deductible only through depreciation or as the basis of property in determining capital gains or losses.

11.2 Minimum Alternative Tax (MAT)

Normally, a company is liable to pay tax on the income computed in accordance with the provisions of the income tax Act, but the profit and loss account of the company is prepared as per provisions of the Companies Act. There were large number of companies who had book profits as per their profit and loss account but were not paying any tax because income computed as per provisions of the income tax act was either nil or negative or insignificant. In such case, although the companies were showing book profits and declaring dividends to the shareholders, they were not paying any income tax. These companies are popularly known as Zero Tax companies. In order to bring such companies under the income tax act net, section 115JA was introduced w.e.f assessment year 1997–98.

Caselet

Zero Tax Companies

A company's book-profit is 10 lakhs Rupees. Then they use some creative accounting methods like depreciation, donations etc. to claim deductions and finally their 'taxable' income is reduced to almost zero. In 2009 during the recession time, Government of India launched a scheme to give 50% depreciation to commercial vehicles. (With assumption that it'll boost the vehicle demand and help the automobile industry to come out of the recession.)

So the company buys a truck, for 20 lakhs rupees on loan. Their deduction on first year= 50% of 20 lakhs rupees= 10 lakhs rupees. Their taxable income = book profit minus deductions =10 minus 10=0. So they don't have to pay any tax on their profit at all. Other tricks involve donating 5,000 rupees to some religious institution run by con-man and getting donation-receipt of 5 lakhs rupees. These companies, making profit but having zero taxable income, are known as Zero tax companies.

Source: http://mrunal.org/2011/04/economy-q-minimum-alternative-tax-mat.html

According to this section, if the taxable income of a company computed under this Act, in respect of previous year 1996–97 and onwards is less than 30 % of its book profits, the total income of such company is chargeable to tax for the relevant previous year shall be deemed to an amount equal to 30 % of such book profits.

Notes *Minimum Alternate Tax (MAT)* is levied on companies as per section 115JB of the Indian Income Tax Act, 1961. And it is levied on limited liability partnerships (LLPs) as per section 115JC.

When a Company has to Pay MAT

In India, in the case of companies, if the tax payable on their taxable income for any assessment year is less than 18.54% of their 'book profit'(if book profit does not exceed ₹ 10 m),or 19.9305%

of book profit (if book profit exceeds ₹ 10 m), an amount equal to 18.54% of the book profit (if book profit does not exceed ₹ 10 m) or 19.9305% of book profit (if book profit exceeds ₹ 10 m) is regarded as their tax liability.

The tax so paid could be carried forward and set off against normal tax (in excess of MAT for that year) of future years up to ten years but from the financial year 2010–11 said carry forward shall not apply to a limited liability partnership which has been converted from a private company or unlisted public company.

Did u know? MAT is applicable in respect of Export Oriented Unit Schemes (EOU) but not Special Economic Zones (SEZ).

Preparing the Annual Accounts

Every assessee, being a company, shall, for the purposes of this section, prepare its profit and loss account for the relevant previous year in accordance with the provisions of Parts II and III of Schedule VI of the Companies Act, 1956.

While preparing the annual accounts including profit and loss account,—

1. the accounting policies,
2. the accounting standards adopted for preparing such accounts including profit and loss account,
3. the method and rates adopted for calculating the depreciation shall be the same as have been adopted for the purpose of preparing such accounts and laid before the company at its annual general meeting in accordance with the provisions of section 210 of the Companies Act, 1956.

Calculating Book Profit

For the purposes of this section, "book profit" means the net profit as shown in the profit and loss account for the relevant previous year, as

Increased by the following amounts debited to Profit and Loss Account:

1. Income-tax paid or payable, and the provision thereof, including
   a. any tax on distributed profits under section 115-O or on distributed income under section 115R,
   b. any interest charged under this Act,
   c. surcharge, if any, as levied by the Central Acts from time to time,
   d. education Cess on income-tax, if any, as levied by the Central Acts from time to time; and
   e. secondary and Higher Education Cess on income-tax, if any, as levied by the Central Acts from time to time.
2. Transfer to Reserves (Other than Section 33AC – w.e.f. AY 2003–2004)
3. Amount set aside to meet unascertained liabilities,
4. Provision for losses of Subsidiaries,
5. Dividends Proposed or Paid,

6. Expenditure relatable to Income (eligible for deduction from Book Profit) exempt under section 10 or 11 or 12,

7. Amount of depreciation, including amount of depreciation on Revalued amount of Fixed Asset,

8. Amount of deferred tax and the provision thereof,

9. Amount or amounts set aside as provision for diminution in the value of any asset.

Such Net Profit, as increased, shall be reduced by the following amounts only, if credited to the Profit and Loss Account:

1. Amount withdrawn from Reserves or Provisions from those created before 01.04.1997 without debiting Profit and Loss Account,

2. Amount withdrawn from reserves created on or after 01.04.1997 if such amount was allowed to be charged to Net Profit for the purpose of Section 115JB or Section 115JA,

3. Income exempt under section 10 [other than 10(38), 10(23G)] or 11 or 12,

4. Amount of Deferred Tax,

5. Amount withdrawn from Revaluation Reserve to the extent it does not exceed the depreciation on revalued amount of Fixed Asset charged to Profit and Loss Account,

6. Amount of depreciation, excluding amount of depreciation on Revalued amount of Fixed Asset,

7. Lower of the following:

   i. Brought Forward Loss (as per Books) – Loss does not include Depreciation,

   ii. Unabsorbed Depreciation (as per Books),

8. Profits eligible for deduction under section 80HHC or 80HHE or 80HHF, up to Assessment Year 2005–06,

9. Amount of Profits of Sick Industrial Company, during the period of sickness.

> *Notes* The aforesaid computation of Book Profit and Minimum Alternate Tax shall not affect the determination of the amounts in relation to the relevant previous year to be carried forward to the subsequent year(s) under the provisions of section 32(2) or of section 32A (3) or section 72(1) (ii) or section 73 or section 74 or of section 74A (3).

MAT Credit

A new tax credit scheme is introduced by which MAT paid can be carried forward for set-off against regular tax payable during the subsequent five year period subject to certain conditions, as under:

- When a company pays tax under MAT, the tax credit earned by it shall be an amount which is the difference between the amount payable under MAT and the regular tax. Regular tax in this case means the tax payable on the basis of normal computation of total income of the company.

- MAT credit will be allowed carry forward facility for a period of five assessment years immediately succeeding the assessment year in which MAT is paid. Unabsorbed MAT credit will be allowed to be accumulated subject to the five year carry forward limit.

- In the assessment year when regular tax becomes payable, the difference between the regular tax and the tax computed under MAT for that year will be set off against the MAT credit available.

Procedure for Computation of MAT under Section 115JB

The provisions of section 115JB provide for working out the income-tax payable as MAT on a deeming basis. The MAT tax liability under section 115JB can be worked out by undergoing the following steps:

1. Compute the total income of the company ignoring the provisions of under Section 115JB.
2. Compute the income-tax payable on total income.
3. Work out the Book Profit under the provisions of section 115JB.
4. Calculate 10 per cent of book profit as per provisions of section 115JB.
5. MAT tax liability which would be the tax payable if it is more than the amount of tax worked.

Example: AB Pvt. Ltd has a tax liability on its normal taxable income of ₹ 3 lakhs.

AB Pvt. Ltd. has book profit of ₹ 20 Lakhs as computed under section 115JB.

Therefore as per section 115JB, tax on the book profit would be ₹ 3.70 Lakhs.

Hence, AB Pvt. Ltd., has to pay tax MAT (i.e., ₹ 3.70 Lakhs), since the normal tax liability (₹ 3.00 Lakhs) is less than 18.5% of the Book Profit.

Self Assessment

Fill in the blanks:

7. Companies who had book profits as per their profit and loss account but are not paying any tax because income computed as per provisions of the income tax act is either nil or negative or insignificant are referred to as ……………..
8. ………………is levied on companies as per section 115JB of the Indian Income Tax Act, 1961.
9. MAT is applicable in respect of Export Oriented Unit Schemes (EOU) but not ………………….
10. ………………..means the net profit as shown in the profit and loss account for the relevant previous year.
11. A …………………is introduced by which MAT paid can be carried forward for set-off against regular tax payable during the subsequent five year period subject to certain conditions.

11.3 Tax on Distributed Profits of Domestic Company

It must be noted that in India the treatment of tax on distributed profits of domestic companies is dealt in by Chapter XIID which contains a special provision relating to tax on distributed profits of domestic companies. This has only three sections, namely section 115 O, which is a charging section and also prescribes the period, the rate of additional tax, which is payable, and time and manner of payment etc. by company on dividend distributed. Section 115-P provides for interest payable for non-payment or delayed payment of additional tax by domestic companies. Section 115-Q is about when company is deemed to be in default.

Basis of Charge

The Dividend Distribution Tax or DDT is in addition to income tax paid by company is:

- Applicable only on domestic companies
- Charged on amount declared, distributed or paid by a domestic company
- Applicable on interim and final dividend.
- Applicable whether the dividend is paid out of current profits or accumulated profits
- Exemption to dividends out of SEZ.

Caution The dividend received by Assessee Company from its subsidiary shall be deducted provided Subsidiary has paid dividend tax same amount is not taken as deduction more than once Assessee is not a subsidiary of any other company

On perusal of section 2(22) we can find that in case of other modes of distribution of profit, the company may distributes such profit in any manner but it will be to all the shareholders in proportion to the number of shares held by them, if all shares are equal in entitlement. In case there are different types of shares, then dividend will be in proportion to paid-up capital thereon and as per the terms of issue.

Whereas in case of payments which are deemed as dividend under clause (e); the payments are not in proportion to the shareholding or paid up capital held by different members. Therefore, the deemed dividend u/s 2(22) (e) is materially different from other types of dividend-covered u/s 2(22).

In fact, the company does not declare a dividend of the nature contemplated in section 2(22)(e), rather the company advances certain money with a condition that the same will be in nature of loan or advance, it may bear interest also and it is refundable.

However, still it is deemed to be dividend in hands of shareholder who receives such payment because the purpose of treating such payment as dividend is to check the practice of giving away money of company to shareholders without paying corporate tax. This being the factual and legal position, it appears that such deemed dividends are excluded from the ambit of section 115 O and the company is therefore, not liable to pay additional tax on such payments.

Example: There is a company named Dividend Rich Manufacturing Company P. Ltd. The company is a manufacturing company and money lending is not its business. Its Paid up capital is ₹ 5,00,000/- (5,00,000 shares of ₹ 1/- each fully paid-up) Its Shareholders are: A, B, C, and D each holding 1,25,000 shares that is each has a stake of 25% and everyone is substantially interested. Dividend declared by the company is ₹ 10/- per share ₹ 50,00,000/-. This dividend will have to be paid in proportion of shares held by the shareholders on the record date. In this case as all shareholders hold equal number everyone will get equal amount of dividend that is ₹12,50,000/- as dividend will be paid to each of A, B, C and D. The company is required to pay additional tax on the sum of ₹ 50,00,000 distributed by way of dividend under section 115 O.

Suppose the company has accumulated a surplus of ₹ 10 crore. It advances a sum of ₹ one crore to Mr. A as loan bearing interest @ 14% p.a. and refundable after one year. Mr. A holds 25% (that is not less than 10% voting power) stake in the company and therefore clause (e) of subsection 22 of section 2 is applicable in his case. Any other shareholder has not taken any loan from the company. Here lies the difference; the loan or advance is not in proportion of capital held.

The sum of ₹ one crore, is not dividend for the purpose of Chapter XII D as it is expressly excluded from the scope of dividend for the purpose of the entire chapter. Therefore, the amount of loan granted to Mr. A, may be deemed dividend under clause (e) of sub section (22) of section 2 but it is not dividend for the purpose of Chapter XII D. Therefore, the company will not be liable to additional tax on this sum. The shareholder Mr. A, may be liable to tax by deeming such sum as dividend u/s 2 (22) (e), unless, he is able to bring it in some exempted category specified in section 2 (22) or if it can be established that the shares are eligible only for a fixed rate of dividend.

Did u know?

Rate of dividend tax from April 1, 2010:

Dividend Tax – 15%

Surcharge – 1.125%

Education cess- 0.3225%

SHEC- 0.16125%

Total dividend Tax: 16.60875%

Time limit for payment of DDT is that it is to be paid within 14 days of Declaration Distribution or Payment of dividend whichever is earlier. Dividend income is exempt under section 10(34) in the hands of recipient. But dividend tax is not a deductible expense in the hands of company.

Self Assessment

State whether the following statements are true or false:

12. The treatment of tax on distributed profits of domestic companies is dealt in by Chapter XIID which contains a special provision relating to tax on distributed profits of domestic companies.
13. Section 115-Q provides for interest payable for non-payment or delayed payment of additional tax by domestic companies.
14. The dividend received by Assessee Company from its subsidiary shall be deducted provided Subsidiary has paid dividend tax.
15. Time limit for payment of DDT is that it is to be paid within 16 days of Declaration Distribution or Payment of dividend whichever is earlier.
16. Dividend income is exempt under section 10(34) in the hands of recipient.

11.4 Tax on Dividend and Income Received from Venture Capital Companies

Venture Capital is a term coined for the capital required by an entrepreneur to 'venture' into something new, promising and unconventional. Investing in a budding company has always been a risky proportion for any financier. The risk of the business failure and the apprehensions of an altogether new project clicking weighed down the small entrepreneurs to get the start-up fund. The Venture Capitalists or the angel investors then came to the forefront with an appetite for risk and willingness to fund the ventures.

At present, the Venture Capital activity in India comes under the purview of different sets of regulations namely:

1. The SEBI (Venture Capital Funds) Regulation, 1996[Regulations] lays down the overall regulatory framework for registration and operations of venture capital funds in India.
2. Overseas venture capital investments are subject to the Government of India Guidelines for Overseas Venture Capital Investment in India dated September 20, 1995.
3. For tax exemptions purposes venture capital funds also needs to comply with the Income Tax Rules made under Section 10(23FA) of the Income Tax Act.

In addition to the above, offshore funds also require FIPB/RBI approval for investment in domestic funds as well as in Venture Capital Undertakings (VCU). Domestic funds with offshore contributions also require RBI approval for the pricing of securities to be purchased in VCU likewise, at the time of disinvestment, RBI approval is required for the pricing of the securities. The provisions of Chapter XII-D or Chapter XII-E or Chapter XVII-B shall not apply to the income paid by a venture capital company or venture capital fund under this Chapter.

Thus taking from the perspective of taxation of income in India you can say that the Venture Capital Undertaking (VCU) is defined under Section 10(23FB) of the Income Tax Act to cover unlisted companies. As per SEBI regulations, a VCU means a domestic unlisted company which is engaged in the business for providing services, production or manufacture of article or things. The company must not belong to such sectors which are specified in the negative list by the Board with the approval of the Central Government by notification in the Official Gazette in this behalf i.e. NBFCs, Gold Financing, etc.

Any amount of income distributed by a venture capital company or venture capital fund to the investors shall be chargeable to tax and such company or fund shall be liable to pay income-tax on such distributed income at the rate of twenty per cent. A venture capital company or venture capital fund shall be liable to pay income-tax at the rate of twenty per cent on any income which is not distributed to the investors within such time as may be specified, with the approval of the Central Government, by the Securities and Exchange Board of India, by notification in the Official Gazette, in this behalf.

The person responsible for making payment of the income distributed by the venture capital company or venture capital fund and the Venture Capital Company or venture capital fund shall be liable to pay tax to the credit of the Central Government within fourteen days from the date of distribution or payment of such income, whichever is earlier.

Clause 108 related to tax on income received from Venture Capital Company and venture capital fund states that any income received by a person out of investments made in a venture capital company or venture capital fund shall be chargeable to income-tax in the same manner as if it were the income received by such person had he made investments directly in the venture capital undertaking.

The venture capital company, the venture capital fund or the person responsible for making payment of the income on behalf of such company or fund shall furnish, within such time as may be prescribed, to the person receiving such income and to the prescribed income-tax authority, a statement in the prescribed form and manner, giving details of the nature of the income paid during the financial year and such other relevant details as may be prescribed.

The income paid by the venture capital company and the venture capital fund shall be deemed to be of the same nature and in the same proportion in the hands of the person receiving such income as it had been received by, or had accrued to, the venture capital company or the venture capital fund, as the case may be, during the financial year.

Moreover the Venture Capital Company or Venture Capital Fund is not liable to make payment of dividend tax under Section 115-O or a tax on distributed income to the unit holders under section 115-R.

Self Assessment

Fill in the blanks:

17. ………………is a term coined for the capital required by an entrepreneur to 'venture' into something new, promising and unconventional.
18. ……………..means a domestic unlisted company which is engaged in the business for providing services, production or manufacture of article or things.
19. The person responsible for making payment of the income distributed by the venture capital company shall be liable to pay tax to the credit of the Central Government within ……………from the date of distribution or payment of such income, whichever is earlier.
20. The Venture Capital Company or Venture Capital Fund is not liable to make payment of dividend tax under …………..

Case Study

Vodafone Investments in India

India Inc. has been surging ahead audaciously with the support of its Information Technology developments with its repertoire of resources. Global players have been eying the Indian market, owing to immense opportunities that the continent provides; both in terms of expansion and profit. Investment patterns in India have shown positive growth over the years with significant process on the de-regulation front. India has been greatly involved with the G-8 and G-20, including signing of the Double Taxations Avoidance Agreements/Treaties (DTAA) with various tax-haven countries. This has boosted the image of India as a 'lookout destination' for investment and an emerging hub for economical activities. World Report 2010 ranked India as the 9th most attractive investment destination, while Bloomberg Global Poll conducted in September 2010 put India in the third position, above the United States of America (US).

However, the very same image is said to have taken a beating with the recent Vodafone Tax case, which has been revolving in courts since 2009. With clear signs of the court ruling in favour of the tax authorities, many global companies are said to be rethinking their investment plans in India, keeping in mind the impact of the judgment on the taxation front. The Doing Business Report 2011 of World Bank has ranked India at 134, below neighbouring countries like Pakistan and Bhutan. This is a result of procedural difficulties for start-up companies and investment companies, in India and abroad.

Tax regulations play a major role in cross border transactions and investments in a country. Tax havens, open borders and DTAA countries are major destinations for investment through Foreign Direct Investment (FDI) or other routes. The Vodafone tax case throws an interesting question on the taxability of a non-resident company acquiring shares of a resident company through an indirect route. This is a landmark case, as it is for the first time that the tax departments have sought to tax a company through a mechanism of tracing the source of acquisition. While we have heard about lifting the 'corporate veil', this instance has set a rare example wherein the Indian tax authorities have gone to length to interpret the existing tax laws, to bring a global company like Vodafone to its tax ambit.

Contd...

Facts

Vodafone International Holdings BV, based in Netherlands and controlled by Vodafone UK, obtained the controlling interest and share of CGP Investments Holdings Ltd (CGP) located in Cayman Island for a value of $11.01 billion from Hutchinson Telecommunications International Ltd (HTIL), which had stake in Hutchinson Essar Ltd (HEL) that handled the company's mobile operations in India. HEL had its stake in CGP Holdings, from which Vodafone bought 52 per cent of HEL's stake in 2007, thereby vesting controlling interest over them. The Bombay High Court, on September 8, ruled that where the underlying assets of the transaction between two or more offshore entities lies in India, it is subject to capital gains tax under relevant income tax laws in India. The Court invoked the nexus rule wherein a state can tax by connecting a person sought to be taxed with the jurisdiction, which seeks to tax. The treatment of the company as an Assessee in Default (AID) under Section 201(1) of the Income Tax Act and reading Sections 5(2), 9(1) and 195, the court came to the conclusion that Vodafone was liable to deduct tax at source (TDS). Vodafone has now appealed before the Supreme Court to revisit the judgment, which makes them liable for a record amount of ₹ 12,000 crores going to the tax authorities' kitty.

Impact

Vodafone raises pertinent questions on the issue of taxation of non-resident entities. The judgment will have direct impact on transactions of major acquisitions like SABMiller-Foster and Sanofi Aventis-Shanta Biotech. Similar transactions that existed earlier are Sesa Goa, AT&T and General Electric. British firm Cairn Energy has already agreed to pay tax in India as well as the UK on selling its stake in Cairn India to Vedanta Resources from $6.65 billion to $8.48 billion. Depending upon the size of the stake sale, the tax liability could range between $868 million and $1.1 billion. The judgment would definitely throw a cautious note to major investors and M&As in India; however, it does not have that great an impact to curtail the investment flow to an emerging destination like India. The judicial propriety of the case is still to be settled when the matter comes for final stages in the Supreme Court. Going by the events in the lower courts, the Supreme Court is unlikely to disturb the Bombay High Court ruling.

The global community is keenly watching the current trends happening in the Indian subcontinent, especially since it has become an emerging player at the socio-economic and political levels. United Nations Conference on Trade and Development (UNCTAD) has reported that India is set to dislodge the US by December 2012 to become the second best destination for FDIs, the major component of which is M&As. India is also set to revamp its taxations norms with significant changes at the regulatory level. The proposed Direct Tax Code contains key provisions, which will have a major impact on investments in India. India has improved its rankings in the WB 'Doing Business' Report on the number of regulatory changes taken in the existing year. This shows that the country is set to make a global footprint by branding itself as a 'Must Invest' destination.

The Vodafone tax case has given India the opportunity to create a model for other countries, which follow source-based taxation principles6. It is an opportune time to bask in the glory of India, which is said to have had one third share of the world market in ancient times, as pointed out by economist Amartya Sen in his book 'The Argumentative Indian'. Let's hope that we can revive the 'Real India' soon.

Notes:

1. Section 201 of the Act broadly provides that any person (referred to in Section 200 of the Act), and in cases referred to in Section 194, the principal officer and the relevant company, who does not deduct the whole or any part of the tax, or after deducting

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fails to pay the tax as required by or under the Act, he or it shall, without prejudice to any other consequences which he or it may incur, be deemed to be an 'assessee in default' in respect of the tax.

2. Section 5(2) enunciates that the income of a non-resident from whatever source derived is included in the total income if (i) it is received in India; (ii) deemed to be received in India; (iii) accrues in India; (iv) deemed to accrue in India; (v) arises in India; or (vi) deemed to arise in India.

3. Section 9(1) explains the circumstances in which income is deemed to accrue or arise in India and includes all income accruing or arising in India, whether directly or indirectly (a) through or from any business connection in India; or (b) through or from any property in India; or (c) through or from any asset or source of income in India; or (d) through the transfer of a capital asset situated in India.

4. Section 195 provides for deduction for tax at source upon a payment to a non-resident or foreign company

5. The proposed DTC says that if 50 per cent of the value of the shares being transferred is derived from assets situated in India, it is deemed to be taxable in India.

6. Countries like India have been following resident-based taxation mechanism, wherein whoever is the resident of India is taxed. Source-based taxation provides for a taxation regime which goes into the source of the asset which is liable for tax.

Questions

1. Study and analyse the case.
2. Write down the case facts.
3. What do you infer from it?

Source: http://www.mindtext.org/view/89/Vodafone_Tax_case_-_A_Case_Study_for_Investments_in_India/

11.5 Summary

- Company whether Indian or foreign is liable to taxation, under the Income Tax Act, 1961. Corporation tax is a tax which is levied on the incomes of registered companies and corporation. However, for the purpose of taxation, companies are broadly classified as domestic company or a foreign company.
- Indian companies are taxable in India on their worldwide income, irrespective of its source and origin. Foreign companies are taxed only on income which arises from operations carried out in India or, in certain cases, on income which is deemed to have arisen in India.
- A Company is said to be resident in India during any relevant previous year if it is an Indian Company; or if the control and management of its affairs is situated wholly in India. In case of Resident Companies, the total income liable to tax includes any income which is received or is deemed to be received in India in the relevant previous year by or on behalf of such company, any income which accrues or arises or is deemed to accrue or arise in India during the relevant previous year and any income which accrues or arises outside India during the relevant previous year.
- The main source of income of a company is generally from "business". A company would also earn income from under the following heads: income from house property, income from capital gains and income from other sources Taxable income is calculated according

to the rules for each class of income and then aggregated to determine total taxable income.

- Business losses incurred in a tax year can be set off against any other income earned during that year, except capital gains. Unabsorbed business losses can be carried forward and set off against business profits of subsequent years for a period of eight years; the unabsorbed depreciation element in the loss can however, be carried forward indefinitely. However, this carry forward benefit is not available to closely-held (private) companies in which there has been no continuity of business or shareholding pattern.
- For companies, income is taxed at a flat rate of 30% for Indian companies. Foreign companies pay 40%. An education cess of 3% (on the tax) is payable, yielding effective tax rates of 33.99% for domestic companies and 41.2% for foreign companies. From the tax year 2005–06, electronic filing of company returns is mandatory.
- In India, in the case of companies, if the tax payable on their taxable income for any assessment year is less than 18.54% of their 'book profit'(if book profit does not exceed ₹ 10 m),or 19.9305% of book profit (if book profit exceeds ₹ 10 m), an amount equal to 18.54% of the book profit (if book profit does not exceed ₹ 10 m) or 19.9305% of book profit (if book profit exceeds ₹ 10 m) is regarded as their tax liability.
- The tax so paid could be carried forward and set off against normal tax (in excess of MAT for that year) of future years up to ten years but from the financial year 2010–11 said carry forward shall not apply to a limited liability partnership which has been converted from a private company or unlisted public company.
- It must be noted that in India the treatment of tax on distributed profits of domestic companies is dealt in by Chapter XIID which contains a special provision relating to tax on distributed profits of domestic companies. This has only three sections, namely section 115 O, which is a charging section and also prescribes the period, the rate of additional tax, which is payable, and time and manner of payment etc. by company on dividend distributed. Section 115-P provides for interest payable for non-payment or delayed payment of additional tax by domestic companies. Section 115-Q is about when company is deemed to be in default.
- Any amount of income distributed by a venture capital company or venture capital fund to the investors shall be chargeable to tax and such company or fund shall be liable to pay income-tax on such distributed income at the rate of twenty per cent. A venture capital company or venture capital fund shall be liable to pay income-tax at the rate of 20 per cent on any income which is not distributed to the investors within such time as may be specified, with the approval of the Central Government, by the Securities and Exchange Board of India, by notification in the Official Gazette, in this behalf.
- The venture capital company, the venture capital fund or the person responsible for making payment of the income on behalf of such company or fund shall furnish, within such time as may be prescribed, to the person receiving such income and to the prescribed income-tax authority, a statement in the prescribed form and manner, giving details of the nature of the income paid during the financial year and such other relevant details as may be prescribed.

11.6 Keywords

DDT: It is the tax levied by the Indian Government on companies according to the dividend paid to a company's investors.

Domestic Company: It is a company formed and registered under the Companies Act, 1956 or any other company which, in respect of its income liable to tax, under the Income Tax Act, has made the prescribed arrangement for declaration and payments within India, of the dividends payable out of such income.

Employees Stock Option Plan: It is a plan through which a company awards Stock Options to the employees based on their performance.

Foreign Company: It is a company whose control and management are situated wholly outside India, and which has not made the prescribed arrangements for declaration and payment of dividends within India.

Fringe Benefit Tax: It is a tax payable by companies against benefits that are seen by employees but cannot be attributed to them individually.

Limited Liability Partnership: It is a partnership in which some or all partners depending on the jurisdiction have limited liability.

VCU: It means a domestic unlisted company which is engaged in the business for providing services, production or manufacture of article or things.

Venture Capital: It is a term coined for the capital required by an entrepreneur to venture into something new, promising and unconventional.

Wealth Tax: It is a tax based on the market value of assets that are owned. These assets include, but are not limited to, cash, bank deposits, shares, fixed assets, private cars, assessed value of real property, pension plans, money funds, owner occupied housing and trusts.

Zero Tax Company: It is a business that shows a book profit and pays dividends to investors but does not pay taxes.

11.7 Review Questions

1. How will you find the residential status of a company?
2. Explain the main sources of income of a company.
3. Mention in detail the expenses which are allowable as deductions while computing the taxable income of a company.
4. Write a short note on important corporate taxes paid by companies in India.
5. Discuss the steps in computation of taxable income of companies.
6. Define MAT.
7. What are zero tax companies? Explain with help of an example.
8. When does a company need to pay MAT?
9. Write a note on calculation of Book profits.
10. Explain the tax on distributed profits of domestic companies in India.
11. Define a Venture Capital Company.
12. Elucidate the provisions for treatment of tax on income or dividends received from a VCC.

Answers: Self Assessment

1.	Source and origin	2.	Deductible
3.	Business losses	4.	30%
5.	Fringe Benefit Tax	6.	Capital expenditure
7.	Zero tax companies	8.	Minimum Alternate Tax (MAT)
9.	Special Economic Zones (SEZ)	10.	Book profit
11.	New tax credit scheme	12.	True
13.	False	14.	True
15.	False	16.	True
17.	Venture capital	18.	VCU
19.	fourteen days	20.	Section 115-O

11.8 Further Readings

Books

Aggarwal, K. *Direct Tax Planning and Management.* Atlantic Publications.

Ahuja, G. K. & Gupta, Ravi. *Systematic Approach to Income Tax.* Bharat Law House.

Lakhotia, R. N. *Income Tax Planning Handbook.* Vision Books.

Singhania, V. K. & Singhania, Kapil. *Direct Taxes Law & Practice.* Taxmann Publications.

Srinivas E. A. *Handbook of Corporate Tax Planning.* Tata McGraw Hill.

Online links

http://business.gov.in/taxation/computation_income.php

http://business.gov.in/taxation/different_taxes.php

http://business.gov.in/taxation/taxation_company.php

http://seminarprojects.com/Thread-tax-on-distributed-profits-of-domestic-companies

http://trak.in/india-tax/corporate-taxes-india/

http://www.accounting-n-taxation.com/Minimum-Alternate-Tax.html

http://www.asiatradehub.com/india/tr13.asp

http://www.madaan.com/taxrates.htm

http://www.solveaccounting.com.au/Blog/tabid/62/EntryId/4/Calculating-a-company-s-taxable-income.aspx

http://www.taxlawsonline.com/news/DTC/chap6/dtc108.asp

Unit 12: Income under the Head Capital Gains

CONTENTS

Objectives

After studying this unit, you will be able to:

- Define Capital Gains and Capital asset
- Discuss the Concept of Transfer
- Describe Short-term and long-term capital gains
- Workout Computation and deductions in Capital Gains
- Explain Capital gains exempt from tax
- Trace the Computation of capital gains in respect of depreciable assets

Introduction

When we buy any kind of property for a lower price and then subsequently sell it at a higher price, we make a gain. The gain on sale of a capital asset is called capital gain. This gain is not a regular income like salary, or house rent. It is a one-time gain; in other words the capital gain is not recurring, i.e., not occur again and again periodically.

Opposite of gain is called loss; therefore, there can be a loss under the head capital gain. We are not using the term capital loss, as it is incorrect. Capital Loss means the loss on account of destruction or damage of capital asset. Thus, whenever there is a loss on sale of any capital asset it will be termed as loss under the head capital gain.

The provisions for computation of Income from capital gains are covered under sections 45 to 55. Section 2(14) defines the term capital gain and section 45, the charging section lays down basis of change for taxability of capital gain or loss arises on transfer of capital asset.

Taxability of capital gain depends upon the nature of capital gain arises, i.e., short term capital gain or long term capital gain. The type of capital gain depends upon the period for which the capital asset is held. The taxability of capital gain shall satisfy the conditions like there should be capital asset, the asset is transferred by the assessee, such transfer takes place during the previous year, etc. To give relief to the assessee, the concept of exemption introduced under different sections.

At the end of this unit, you will learn the conditions to be satisfied for income to be chargeable under this head, which assets are classified as capital asset, the year in which the capital gains are chargeable to tax, classification of capital gain into long-term and short-term, which are the transactions not regarded as transfer, what are the exemptions available in respect of capital gains and when the assessing officer can make a reference to the valuation officer.

12.1 Capital Gains

Under the Income Tax Act, any profits or gains arising from the transfer of a capital asset effected in the previous year, shall be chargeable to income tax under the head 'capital gains' and shall deemed to be the income of the previous year in which the transfer took place unless such capital gain is exempted under the prescribed exemptions.

'Capital gains' means any profit or gains arising from transfer of a capital asset. If any Capital Asset is sold or transferred, the profits arising out of such sale are taxable as capital gains in the year in which the transfer takes place. Capital gains are the difference between the price at which the capital asset was acquired and the price at which the same asset was sold. In technical terms, capital gain is the difference between the cost of acquisition and the fair market value on the date of sale or transfer of asset.

Sections 45 to 55A of the Income-tax Act, 1961 Deal with Capital Gains

Section 45 of the Act, provides that any profits or gains arising from the transfer of a capital asset effected in the previous year shall, save as otherwise provided in Sections 54, 54B, 54D, 54EC, 54ED, 54F, 54G, 54GA and 54H be chargeable to income-tax under the head "Capital Gains" and shall be deemed to be the income of the previous year in which the transfer took place.

Doubts may arise as to whether 'Capital Gains' being a capital receipt can be brought to tax as income. It may be noted that the ordinary accounting canons of distinctions between a capital receipt and a revenue receipt are not always followed under the Income-tax Act. Section 2(24)(vi) of the Income-tax Act specifically provides that "Income" includes "any capital gains chargeable under Section 45(1)". It may not be out of place to mention here that in the absence of a specific provision in Section 2(24) capital gains has no logic to be taxed as income.

Caution However, all capital profits do not necessarily constitute capital gains. For instance, profits on re-issue of forfeited shares, profits on redemption of debentures, premium on issue of shares, 'pagri' from tenants etc. are capital profits and not capital gains, hence, not liable to tax. The requisites of a charge to income-tax, of capital gains under Section 45(1) are:

1. There must be a capital asset.

Notes

2. The capital asset must have been transferred.
3. The transfer must have been affected in the previous year.
4. There must be a gain arising on such transfer of a capital asset. These requisites are briefly analysed below.
5. Such capital gain should not be exempt under Sections 54, 54B, 54D, 54EC, 54ED, 54F, 54G, or 54GA.

The capital gain is chargeable to income tax if the following conditions are satisfied:

1. There is a capital asset.
2. Assessee should transfer the capital asset.
3. Transfer of capital assets should take place during the previous year.
4. There should be gain or loss on account of such transfer of capital asset.

Caselet

Share Trading Income: Business Gain or Capital Gain?

Share trading has grown significantly in the last decade due to rise of the stock market and rapid adoption of technology. It is seen as a way to make quick bucks by a lot of people. However there is a lot of confusion among on how to treat the income earned from trading shares viz. Business gain or a capital gain. It is very important to know the difference because the tax liability of an individual will depend on this, as the tax treatment of Capital gains and Business income are completely different.

As per the income tax department, any purchase of shares made with the motive of earning profit is considered to be Business income, whereas investments made with the intent of earning income through dividends will amount to capital gain.

For Example, if Mr. Saket has earned ₹ 1,00,000 by trading in shares for a short-term i.e. by intraday trading or trading in F&O, it is taxable under the head Income from Business or Profession as per the tax slab applicable to him. While if he holds the shares for a considerable period time to accumulate wealth then it comes under head Income from Capital gains (if it is for period exceeding 12 months then no tax is levied provided STT paid. If it is for a period not exceeding 12 months then he will charged at 15% on his net gain).

It also mentions that an individual can have two portfolios under the head Capital Gains and Business income, which means that if an individual earns income from intraday trading and F&O and also from investment in shares for considerable time to accumulate wealth then he can have portfolios under both the heads of income i.e. income from intraday Trading and F&O comes under Business Income while Investment in shares with the intent of accumulating profits comes under Capital Gains.

Thus, what matters is the intention of an individual whether he holds for a longer period of time to accumulate profits which constitutes the capital gain or does trading to earn profit (day to day) which constitutes the same to be treated as the business income.

Conclusion

Every individual should be very careful in characterization of income from share trading as capital gain or Business income because this characterization will affect the tax liability of the individual to a great extent. Suppose if you wrongly characterize your Long-term

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> Capital gain of ₹ 1,00,000 as business income then you will be charged tax at rate of 30% that will amount to ₹ 30,000 (Assuming you belong to highest Tax bracket) while the long term capital gains from shares are exempted provided STT paid. Thus you may end up paying extra tax.

Source: http://taxindia.pz10.com/2013/07/share-trading-income-business-gain-or.html

Self Assessment

Fill in the blanks:

1. …………………………..means any profit or gains arising from transfer of a capital asset.
2. ………………………….of the Act, provides that any profits or gains arising from the transfer of a capital asset affected in the previous year shall be chargeable to income-tax under the head Capital Gains.
3. If any Capital Asset is ………………………..the profits arising out of such sale are taxable as capital gains in the year in which the transfer takes place.
4. Doubts may arise as to whether Capital Gains being a ………………………..can be brought to tax as income.

12.2 Capital Asset

Unless the gain is relatable to a capital asset there can be no charge to capital gains tax. Section 2(14) of the Income-tax Act defines the term "capital asset" to mean:

Property of any kind held by an assessee whether or not connected with his business or profession but does not include:

1. Any stock-in-trade, consumable stores or raw-materials held for the purposes of his business or profession
2. Personal effects that is to say, movable property (including wearing apparel and furniture but excluding jewellery) held for personal use by the assessee or any member of his family dependent on him. Jewellery includes ornaments made of gold, silver, platinum or any other precious metal or any alloy containing one or more of such precious metals, whether or not containing any precious or semi-precious stone, and whether or not worked or sewn into any wearing apparel and precious or semi-precious stones, whether or not set in any furniture, utensil or other article or worked or sewn into any wearing apparel
3. Agricultural land in India, not being land situate (a) within the jurisdiction of a municipality or a cantonment board and which has a population of not less than 10,000 according to the last preceding census, or (b) in any area within such distance, not being more than eight kilometres from the local limits of any Municipality or cantonment board, as the Central Government may, having regard to the extent of any scope for urbanisation of that area and other relevant considerations, specify in this behalf by notification in the Official Gazette;
4. 6½ per cent Gold Bonds, 1977 or 7 per cent Gold Bonds, 1980 or National Defence Gold Bonds, 1980 issued by the Central Government;
5. Special Bearer Bonds 1991 issued by the Central Government.
6. Gold Deposit Bonds issued under the Gold Deposit Scheme, 1999 notified by the Central Government.

The Supreme Court in the case of Vodafone International Holdings B.V vs. Union of India [2012] 204 Taxman 408 held that influence or persuasion of a parent company over its subsidiary could not be construed as a right in the legal sense.

To supersede this ruling with retrospective effect from 1st April 1962, an Explanation has been inserted to clarify that 'property' includes and shall be deemed to have always included any rights in or in relation to an Indian company, including rights of management or control or any other rights whatsoever.

The term 'property' appearing in Section 2(14) has not been defined in the Income-tax Act. Even the Transfer of Property Act does not contain any definition of the term. But, the scope of Section 2(14) is very wide. With the exception of the aforementioned assets, all other assets are included in the category of capital asset. "Capital asset" includes movable or immovable asset, tangible or intangible assets, incorporeal rights and chose-in-action. It would also include share of a partner in a firm, goodwill of a firm, mining rights, industrial licence acquired by consideration, tenancy right or leasehold right, foreign currency, right to subscribe for shares, the contractual right of a purchaser to obtain title to an immovable property, etc.

However, with effect from Assessment Year 1988–89, Section 55 is amended to remove this legal difficulty. It provides that where goodwill is self-generated, the cost of acquisition for computation of capital gain shall be deemed to be nil and where it has been purchased, the cost will be taken to be the actual price paid for it. The cost of improvement also in relation to goodwill is taken to be nil.

The Government has overcome the problem of taxing capital gains on transfer of three other categories of self generated assets: with effect from the assessment year 1995–96, cost of tenancy rights, route permits and loom hours would also be deemed to be nil.

From Assessment year 2008–09, the scope of Section 2(14) has been indexed with the introduction of taxability provision with regards to "personal effects being archaeological collections".

Notes In a simple terms we can say that any income profit or gains arising from the transfer of a capital asset is chargeable as capital gains. Now let us understand the meaning of capital asset. Capital Asset means property of any kind, whether fixed or circulating, movable or immovable, tangible or intangible, held by the assessees whether or not connected with his business or profession, but does not include, i.e., Capital Assets exclude:

1. Stock in trade held for business
2. Agricultural land in India not in urban area i.e., an area with population more than 10,000.
3. Items of personal effects, i.e., personal use excluding jewellery, costly stones, silver, gold
4. Special bearer bonds 1991
5. 6.5%, 7% Gold bonds & National Defence Bonds 1980.
6. Gold Deposit Bonds 1999.

There are two types of Capital Assets:

1. ***Short-term Capital Assets (STCA):*** An asset, which is held by an assessee for less than 36 months, immediately before its transfer, is called Short Term Capital Assets. In other words, an asset, which is transferred within 36 months of its acquisition by assessee, is called Short Term Capital Assets.

2. ***Long-term Capital Assets (LTCA):*** An asset, which is held by an assessee for 36 months or more, immediately before its transfer, is called Long Term Capital Assets. In other words, an asset, which h is transferred on or after 36 months of its acquisition by assessee, is called Long Term Capital Assets.

The period of 36 months is taken as 12 months under following cases:

- Equity or Preference shares,
- Securities like debentures, government securities, which are listed in recognised stock exchange,
- Units of UTI
- Units of Mutual Funds
- Zero Coupon Bonds

Self Assessment

State whether the following statements are true or false:

5. Unless the gain is relatable to a capital asset there can be no charge to capital gains tax.
6. The term 'property' appearing in Section 2(14) has been defined in the Income-tax Act.
7. Where goodwill is self-generated, the cost of acquisition for computation of capital gain shall be deemed to be nil.
8. An asset, which is held by an assessee for less than 36 months, immediately before its transfer, is called Short-term Capital Assets.

12.3 Concept of Transfer

Capital gain arises on transfer of capital asset; so it becomes important to understand what the meaning of word transfer is. The word transfer occupy a very important place in capital gain, because if the transaction involving movement of capital asset from one person to another person is not covered under the definition of transfer there will be no capital gain chargeable e to income tax. Even if there is a capital asset and there is a capital gain.

The word transfer under income tax act is defined under section 2(47). As per section 2 (47) Transfer, in relation to a capital asset, includes sale, exchange or relinquishment of the asset or extinguishments of any right therein or the compulsory acquisition thereof under any law.

In simple words Transfer includes:

- Sale of asset
- Exchange of asset
- Relinquishment of asset (means surrender of asset)
- Extinguishments of any right on asset (means reducing any right on asset)
- Compulsory acquisition of asset.

The definition of transfer is inclusive, thus transfer includes only above said five ways. In other words, transfer can take place only on these five ways. If there is any other way where an asset is given to other such as by way of gift, inheritance etc. it will not be termed as transfer.

Task Which the following transactions are transfer in relation to capital asset.

1. A house transferred by way of will to son.
2. Bonus shares given by a company to its shareholders.
3. Giving away jewellery for a piece of land.
4. Getting money in lieu of shop in a shopping complex.
5. Giving the rights to use the asset.

12.3.1 Transactions which do not Constitute Transfer [Sections 46 and 47]

The following transactions are not considered as transfer:

1. Any distribution of capital assets on the total or partial partition of a Hindu Undivided Family.
2. Any transfer of a capital asset under a gift or will or an irrevocable trust; Provided that this clause shall not apply to transfer under a gift or an irrevocable trust of a capital asset being shares, debentures or warrants allotted by a company directly or indirectly to its employees under the Employees' Stock Option Plan or Scheme of the company offered to such employees in accordance with the guidelines issued by the Central Government in this behalf.
3. Any transfer of a capital asset by a company to its subsidiary company, if:
   (a) the parent company or its nominees hold the whole of the share capital of the subsidiary company, and
   (b) the subsidiary company is an Indian company.
4. Any transfer of a capital asset by a subsidiary company to the holding company, if:
   (a) the whole of the share capital of the subsidiary company is held by the holding company, and
   (b) the holding company is an Indian company.
5. Any transfer, in a scheme of amalgamation, of a capital asset by the amalgamating company to the amalgamated company if the amalgamated company is an Indian company.
6. Any transfer in a scheme of amalgamation of a capital asset being share or shares held in an Indian Company, by the amalgamating foreign company to the amalgamated foreign company, if:
   (a) at least twenty-five per cent of the shareholders of the amalgamating foreign company continue to remain shareholders of the amalgamated foreign company; and
   (b) such transfer does not attract tax on capital gains in the country, in which the amalgamating company is incorporated (applicable from the assessment year 1993–94).
7. Any transfer by a shareholder, in a scheme of amalgamation, of a capital asset being a share or shares held by him in the amalgamating company, if:

(a) the transfer is made in consideration of the allotment to him of any share or shares in the amalgamated company except where the shareholders itself is the amalgamated company, and the amalgamated company is an Indian company.

8. Any transfer of agricultural land in India effected before the first day of March, 1970.

9. Any transfer of a capital asset being any work of art, archaeological, scientific or art collection, book, manuscript, drawing, painting, photograph or print to the Government or a University or the National Museum, National Art Gallery, National Archives or any such other public museum or institution as may be notified by the Central Government in the Official Gazette to be of national importance or to be of renown throughout any State or States any transfer by way of conversion of bonds or debentures, debenture stock or deposit certificates in any form, of a company, into shares or debentures of that company.

10. Any transfer made on or before 31.12.1998 by a person not being a company of a capital asset being membership of a recognised stock exchange to a company in exchange for shares allotted by that company to him (transferor).

11. Any transfer of land by a sick industrial company made at any time beginning with declaration of it being sick by the BIFR and ending with the previous year in which its net worth wipes out the accumulated losses.

12. Where a firm is succeeded by a company in the business carried on by it as a result of which the firm sells or otherwise transfers any capital asset or intangible asset to the company: Any transfer of a capital asset or intangible asset by a firm to a company as a result of succession of the firm by a company in the business carried on by the firm, or any transfer of a capital asset to a company in the course of the demutualisation or corporatisation of a recognised stock exchange in India as a result of which an association of persons or body of individuals is succeeded by such company.

13. Any transfer of a capital asset being a membership right held by a member of a recognised stock exchange in India for acquisition of shares and trading or clearing rights acquired by such member in that recognised stock exchange in accordance with a scheme for demutualisation or corporatisation which is approved by the Securities and Exchange Board of India established under Section 3 of the Securities and Exchange Board of India Act, 1992 (15 of 1992).

14. Any transfer of a capital asset or intangible asset by a private company or unlisted public company (hereafter in this clause referred to as the company) to a limited liability partnership or any transfer of a share or shares held in the company by a shareholder as a result of conversion of the company into a limited liability partnership.

15. Where a sole proprietary concern is succeeded by a company in the business carried on by it as a result of which the sole proprietary concern sells or otherwise transfers any capital asset or intangible asset to the company.

16. Any transfer in a scheme for lending of any securities under an agreement or arrangement, which the assessee has entered into with the borrower. Of such securities and which is subject to the guidelines issued by the Securities and Exchange Board of India, established under Section 3 of the Securities and Exchange Board of India Act, 1992 or the Reserve Bank of India in this regard.

17. Any transfer of a capital asset in a transaction of reverse mortgage under a scheme made and notified by the Central Government.

Thus, transfer of capital assets falling in any of the categories discussed above would not attract liability to capital gains tax.

Caution The following points should be noted:

The fact that a transfer becomes void under Section 281 of the Act does not in any way preclude levy of capital gains tax. In the case of transfer of shares held as capital asset, the date of transfer is the date of delivery of the share certificates to the transferee and not the date of registration of the shares in the name of the transferee in the register of company. This apart, it is essential that on the date of transfer the asset should have been held as capital asset in order to attract Section 45 of the Act. Further the notional profit arising from transfer by way of conversion of capital asset into stock-in-trade will be chargeable to tax in the year in which stock-in-trade is sold.

For the purpose of computing the capital gain in such cases, the fair market value of the capital asset on the date on which it was converted or treated as stock-in-trade will be deemed to be the full value of consideration receiving or accruing as a result of the transfer of the capital asset.

Self Assessment

Fill in the blanks:

9. Capital gain arises on ………………………..of capital asset.
10. The word transfer under income tax act is defined under…………………………….
11. If there is any other way where an asset is given to other such as by way of ………………………. it will not be termed as transfer.
12. The fact that a transfer becomes void under …………………….. of the Act does not in any way preclude levy of capital gains tax.

12.4 Short-term and Long-term Capital Gains

Let us now discuss the concept of capital gains and capital assets in detail.

Any capital gain arising as a result of transfer of a short-term capital asset is known as short-term capital gain. According to Section 2(42A) of the Income-tax Act:

"Short term" capital asset means a capital asset held by an assessee for not more than thirty-six months immediately preceding the date of its transfer. In the case of capital assets (being equity or preference share in a company) held by an assessee for not more than 12 months immediately prior to its transfer.

In determining the period for which a capital asset is held by an assessee, the following must be noted:

1. In the case of shares held in a company in liquidation, the period subsequent to the date on which the company goes into liquidation shall be excluded.
2. In case the asset becomes the property of the assessee under the circumstances the period for which the asset was held by the previous owner shall be included.
3. In the case of the shares in an Indian Company which become the property of the assessee in a scheme of amalgamation, the period for which the shares in the amalgamating company were held by the assessee shall be included.

4. In the case of a capital asset, being a share or any other security subscribed to by the assessee on the basis of his right to subscribe to such financial asset or subscribed to by the person in whose favour the assessee has renounced his right to subscribe to such financial asset, the period shall be reckoned from the date of allotment of such financial asset.

5. In the case of capital assets, being the right to subscribe to any financial asset, which is renounced in favour of any other person, the period shall be reckoned from the date of the offer of such right by the company or institution, as the case may be, making such offer.

6. In the case of a capital asset, being a financial asset, allotted without any payment and on the basis of holding of any other financial asset, the period shall be reckoned from the date of the allotment of such financial asset.

7. In the case of a capital asset, being a share or shares in an Indian company, which becomes the property of the assessee in consideration of a demerger, there shall be included the period for which the share or shares held in the demerged company were held by the assessee.

8. In the case of a capital asset, being trading or clearing rights of a recognized stock exchange in India acquired by a person pursuant to demutualisation or corporatisation of the recognized stock exchange in India as referred to in Clause (xiii) of Section 47, there shall be included the period for which the person was a member of the recognized stock exchange in India immediately prior to such demutualisation or corporatisation.

9. In the case of a capital asset, being equity share or shares in a company allotted pursuant to demutualisation or corporatisation of a recognised stock exchange in India as referred to in Clause (xiii) of Section 47, there shall be included the period for which the person was a member of the recognized stock exchange in India immediately prior to such demutualisation or corporatisation.

Notes **Calculation of Short Term Capital Gains (STCG)**

Value of consideration

Less: expenditure incurred wholly and exclusively in connection with such transfer

Less: cost of acquisition

Less: cost of improvement

Less: Exemption(s) available, if any.

The balancing amount is short-term capital gain

Assets other than short-term capital assets are known as 'long-term capital assets' and the gains arising therefrom are known as 'long-term capital gains'. Note that with effect from assessment year 1988–89, a share, equity or preference held by an assessee would be regarded as a long-term capital asset if the ownership is for more than 12 months with him. In the case of other long-term capital assets, the period of holding is determinable subject to any rules made by CBDT.

Zero Coupon Bonds

The Finance Act, 2005 has introduced the procedure regarding the taxation of the income on the Zero Coupon Bonds being issued on or after 1.6.2005. "Zero Coupon Bond" as defined under Section 2(48) means a bond:

(a) Issued by any infrastructure capital company or infrastructure capital fund or public sector company on or after the 1st day of June, 2005;

(b) In respect of which no payment or benefit is received or receivable before maturity or redemption from infrastructure capital company or infrastructure capital fund or public sector company; and

(c) Which the Central Government may, by notification in the Official Gazette, specify in this behalf.

For the purpose of this clause, the expressions "infrastructure capital company" and "infrastructure capital fund" shall have the same meanings respectively assigned to them under clauses (a) and (b) of Explanation 1 to clause (23G) of Section 10.

As per Clause (b) above, the payment of and benefit from zero coupon bond shall be received or receivable from the issuing company or fund only at the time of maturity or redemption. Consequently, Clause (via) has been inserted in Section 2(47) to provide that the maturity or redemption of a zero coupon bond shall be regarded as a transfer. The profits arising on the transfer of such zero coupon bond shall be chargeable under the head "capital gains". Further, Section 2(42A) has been amended to provide that if such zero coupon bonds are held for not more than 12 months, such capital asset shall be treated as short-term capital asset and hence shall be subject to short-term capital gain. On the other hand, where these bonds are held for more than 12 months, such capital gain shall be treated as long-term capital gain.

The proviso under Section 112(1) has been amended to include zero coupon bonds. Therefore, where the tax payable in respect of any income arising from the transfer of a long-term capital asset being zero coupon bonds exceeds 10% of the amount of capital gain, before giving effect to the provisions of the second proviso to Section 48 (i.e. before giving effect to indexed cost) such excess shall be ignored for the purpose of computing the tax payable by the assessee.

Notes Long term capital gain on zero coupon bonds shall be chargeable to tax at minimum of the following two:

(a) 20% of long term capital gain after indexation of cost of such bonds, or

(b) 10% of long term capital gain before indexation of cost of such bonds.

Calculation of Long Term Capital Gains (LTCG)

Full value of consideration

Less: cost of acquisition

Less: expenditure incurred wholly and exclusively in connection with such transfer

Less: indexed cost of improvement

Less: Exemption(s) available, if any.

The balancing amount is long-term capital gain

The STCG and LTCG computed as above are taken as income under the head Capital Gains for the purposes of determining the total income. Full Value of Consideration This is the amount for which a capital asset is transferred. It may be in money or money's worth or a combination of both.

Where the transfer is by way of exchange of one asset for another, fair market value of the asset received is the full value of consideration. Where the consideration for the transfer is partly in cash and partly in kind fair market value of the kind portion and cash consideration together constitute full value of consideration.

Self Assessment

State whether the following statements are true or false:

13. Any capital gain arising as a result of transfer of a short-term capital asset is known as short-term capital gain.
14. Short-term capital asset means a capital asset held by an assessee for more than thirty-six months immediately preceding the date of its transfer.
15. Assets other than short-term capital assets are known as long-term capital assets
16. The Finance Act, 2005 has introduced the procedure regarding the taxation of the income on the Zero Coupon Bonds being issued on or after 1.6.2005.

12.5 Computation and Deductions in Capital Gains

Section 48 of the Act provides that the income chargeable under the head 'capital gains' shall be computed by deducting from the full value of consideration received or accruing as a result of the transfer of the capital asset the following amounts, namely (as applicable from the assessment year 1993–94):

1. The expenditure incurred wholly and exclusively in connection with such transfer;
2. The cost of acquisition of the capital asset and the cost of any improvement thereto.

However, in the case of an assessee who is a non-resident, capital gains arising from the transfer of a capital asset, being shares in, or debentures of, an Indian company shall be computed by converting the cost of acquisition, expenditure incurred wholly and exclusively in connection with such transfer and the full value of the consideration received or accruing as a result of the transfer of the capital asset into the same foreign currency as was initially utilised in the purchase of the shares or debentures, and the capital gains so computed in such foreign currency shall be reconverted into Indian currency.

Further, the above manner of computation of capital gains shall be applicable in respect of capital gains accruing or arising from every re-investment thereafter in, and sale of, shares in, or debentures of, an Indian Company.

Where long term capital gain arises from the transfer of a long term capital asset (other than capital gain arising to a non-resident from the transfer of shares in or debentures of an Indian company), such long term capital gains will be computed by deducting from the full value of consideration, the expenditure incurred in connection with the transfer, the 'indexed cost of acquisition' and 'indexed cost of improvement'.

The Finance Act, 1997 has with effect from 1.4.1998 denied the benefit of indexation of cost of bonds and debentures other than indexed bonds issued by the government.

Provided also that where shares, debentures or warrants referred to in the proviso to Clause (iii) of Section 47 are transferred under a gift or an irrevocable trust, the market value on the date of such transfer shall be deemed to be the full value of consideration received or accruing as a result of transfer for the purposes of this section.

Caution For this purpose:

1. "Foreign currency" and "Indian currency" have the meanings respectively assigned thereto in Section 2 of the Foreign Exchange Management Act, 1999, and

2. The conversion of Indian currency into foreign currency and the re-conversion of foreign currency into Indian currency shall be at the rate of exchange prescribed in that behalf;

3. 'Indexed cost of acquisition' means an amount which bears to the cost of acquisition the same proportion as Cost Inflation Index for the year in which the asset is transferred bears to the Cost Inflation Index for the first year in which the asset was held by the assessee or for the year beginning on the 1st day of April 1981 whichever is later;

4. 'Indexed cost of any improvement' means an amount which bears to the cost of improvement the same proportion as Cost Inflation Index for the year in which the asset is transferred bears to the Cost Inflation Index for the year in which the improvement to the asset took place; and

5. 'Cost inflation index', in relation to a previous year, means such Index as the Central Government may, having regard to seventy-five per cent of average rise in the Consumer Price Index for urban non-manual employees for the immediately preceding previous year to such previous year, by notification in the Official Gazette, specify in this behalf.

Commission paid to a broker for effecting sale of the asset falls under (1) above. Similarly expenditure incurred on litigation for getting enhanced compensation is expenditure wholly and exclusively incurred in connection with transfer of the capital asset and is deductible. However, litigation expenses incurred for having the shares registered in his name are part of the cost of acquisition and that incurred for gaining better voting rights is cost of improvement. Section 48 of the Act does not an Assessing Officer from taking into amount sale consideration stated in the deed or actual consideration received by the assessee whichever is higher.

12.5.1 Cost of Acquisition

Cost of Acquisition (COA) means any capital expense at the time of acquiring capital asset under transfer, i.e., to include the purchase price, expenses incurred up to acquiring date in the form of registration, storage etc. expenses incurred on completing transfer.

In other words, Cost of acquisition of an asset is the sum total of amount spent for acquiring the asset.

Where the asset was purchased, the cost of acquisition is the price paid. Where the asset was acquired by way of exchange for another asset, the cost of acquisition is the fair market value of that other asset as on the date of exchange. Any expenditure incurred in connection with such; purchase, exchange or other transaction e.g. brokerage paid, registration charges and legal expenses also forms part of cost of acquisition.

Sometimes advance is received against agreement to transfer a particular asset. Later on, if the advance is retained by the tax payer or forfeited for other party's failure to complete the transaction, such advance is to be deducted from the cost of acquisition.

Cost of Acquisition with reference to Certain Modes of Acquisition

Where the capital asset became the property of the assessee:

1. on any distribution of assets on the total or partial partition of a Hindu undivided family

2. under a gift or will:

   (a) by succession, inheritance or devolution;

Notes

(b) on any distribution of assets on the dissolution of a 'firm, body of individuals, or other association of persons, where such dissolution had taken place at any time before 01.04.1987;

(c) on any distribution of assets on the liquidation of a company;

(d) under a transfer to a revocable or an irrevocable trust;

(e) by transfer in a scheme of amalgamation;

(f) by an individual member of a Hindu Undivided Family living his separate property to the assessee HUF any time after 31.12.1969.

The cost of acquisition of the asset shall be the cost for which the previous owner of the property acquired it, as increased by the cost of any improvement of the asset incurred or borne by the previous owner or the assessee, as the case may be, till the date of acquisition of the asset by the assessee. If the previous owner had also acquired the capital asset by any of the modes above, then the cost to that previous owner, who had acquired it by mode of acquisition other than the above, should be taken as cost of acquisition.

Where the cost for which the previous owner acquired the property cannot be ascertained the cost of acquisition to the previous owner means the fair market value on the date on which the capital asset became the property of the owner.

Where the capital asset, being a share or debenture in a company, the cost of acquisition of the asset to the assessee shall be deemed to be that part of the cost of debenture, debenture-stock or deposit certificates in relation to which such asset is acquired by the assessee. Accordingly the cost of acquisition of rights share is the amount paid by the assessee to get them and the cost of acquisition of bonus shares is nil.

Concept of Indexation

The value of a rupee today is not same as will be its value tomorrow because of inflation. Likewise to be fair when paying capital gain tax, the effect of inflation on the purchase is included. For instance if you bought a flat in January 2002 for ₹ 20 lakh and sold it in January 2011 for ₹ 35 lakh; you don't pay tax on the ₹ 15 lakh gain. The tax authorities allow the concept of indexation so that you can show a higher purchase cost, lowering the overall profit and reducing the tax you pay on the gain. Using the inflation index, one needs to increase the purchase price of the asset to reflect inflation-adjusted true price in the year of sale.

Indexed Cost of Acquisition = (Cost Inflation Index (CII) for year in which asset is transferred or sold) divided by CII for year in which asset was acquired or bought). The CII is then multiplied with the purchase price to arrive at the indexed cost of acquisition which is the actual or true cost at the time of tax computation or calculation.

$$\text{Indexed Cost of Acquisition} = \text{COA} \times \frac{\text{CII of Year of transfer}}{\text{CII of Year of acquisition}}$$

The indices for the various previous years are given below:

S. No.	Financial Year	Cost Inflation Index
1	1981-82	100
2	1982-83	109
3	1983-84	116
4	1984-85	125

Contd...

5	1985-86	133
6	1986-87	140
7	1987-88	150
8	1988-89	161
9	1989-90	172
10	1990-91	182
11	1991-92	199
12	1992-93	223
13	1993-94	244
14	1994.95	259
15	1995-96	281
16	1996-97	305
17	1997-98	331
18	1998-99	351
19	1999-00	389
20	2000-01	406
21	2001-02	426
22	2002-03	447
23	2003-04	463
24	2004-05	480
25	2005-06	497
26	2006-07	519
27	2007-08	551
28	2008-09	582
29	2009-10	632
30	2010-11	711
31	2011-12	785
32	2012-13	852
33	2013-14	939

Notes If capital assets were acquired before 1.4.81, the assessees has the option to have either actual cost of acquisition or fair market value as on 1.4.81 as the cost of acquisition. If assesses chooses the value as on 1.4.81 then the indexation will also be done as per the CII of 1981 and not as per the year of acquisition.

12.5.2 Cost of Improvement

Cost of improvement is the capital expenditure incurred by an assessee for making any addition or improvement in the capital asset. It also includes any expenditure incurred in protecting or curing the title. In other words, cost of improvement includes all those expenditures, which are incurred to increase the value of the capital asset.

$$\text{Indexed Cost of improvement} = \text{COA} \times \frac{\text{CII of Year of transfer}}{\text{CII of Year of improvement}}$$

Any cost of improvement incurred before 1st April 1981 is not considered or it is ignored. The reason behind it is that for carrying any improvement in asset before 1st April 1981, asset should have been purchased before 1st April 1981. If asset is purchased before 1st April we consider the fair market value. The fair market value of asset on 1st April 1981 will certainly include the improvement made in the asset.

Example: On 15th November, 2012 Rohan sold 1 kg of gold, the sale consideration of which was 4, 50,000. He acquired the gold on August 18, 1978 for 64,000. Fair market value of 1 kg of gold on April 1, 1981 was 62,000. Find out the amount of capital gain chargeable to tax for the assessment year 2013–14 using the cost inflation index table as given.

Solution:

Computation of capital gains:

Sale proceeds of gold	4, 50,000
Less: Indexed Cost of Acquisition	5, 28,240
Long-term Capital loss	78,240

In this case since the asset was purchased before 1.4.1981 and fair market value of gold as on 1.4.1981 is more than the cost of acquisition of gold, it is beneficial for the assessee to opt for Fair Market Value of gold as on 1.4.1981 for computation of capital gains.

Fair Market Value of Gold on 1.4.1981	62,000
Cost inflation index - For the year 1981–82	100

Indexed cost of acquisition = 62,000 × 852/10 = 5, 28,240

12.5.3 Tax on Long-term Capital Gains (Section 112)

Section 112 has been inserted with effect from April 1, 1993 for computation of Income-tax on Long-term Capital gains. Long-term Capital gains will be taxable at a flat rate 20%.

Finance Act, 1999 with effect from assessment year 2000–01 has provided that:

In respect of listed securities or units or zero tax coupon bonds, assessee have the option of:

1. Paying tax @ 20% on long-term capital gain computed by considering the 'indexed' cost of acquisition and improvement; or
2. Paying tax @ 10% on long-term capital gains computed by considering the actual i.e. the historical cost.

This option can be exercised separately in respect of each transaction i.e. exercise of the first option in respect of one transaction does not preclude the assessee from exercising the second option in respect of a subsequent transaction(s) during the same previous year.

Assessee must exercise this choice judiciously on a comparison of tax liability under the two options. In respect of long-term capital gains from transfer of bonus shares, invariably the second option will be exercised.

The assets covered under this provision are securities defined under Section 2(h) of the Securities Contracts (Regulation) Act, 1956 listed on any recognised stock exchange in India.

As per Section 2(h) Securities includes shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature of any company, Government Securities and other notified instruments.

In respect of such long-term capital gain, deductions under Chapter VIA (i.e. under Sections 80C to 80U) are not allowed. Further, income other than long term capital gains will be subject to tax at the rates in force.

Self Assessment

Fill in the blanks:

17. ………………………………..means any capital expense at the time of acquiring capital asset under transfer.
18. Where the cost for which the previous owner acquired the property cannot be ascertained the cost of acquisition to the previous owner means the ………………………on the date on which the capital asset became the property of the owner.
19. …………………… is the capital expenditure incurred by an assessee for making any addition or improvement in the capital asset.
20. Long-term Capital gains will be taxable at a flat rate of………………………

12.6 Capital Gains Exempt from Tax

Under different Sections of the Act, capital gains arising from the transfer of certain capital assets are exempt from tax under certain circumstances. These provisions are dealt with section wise below:

Section 54: In case the asset transferred is a long term capital asset being a residential house, and if out of the capital gains, a new residential house is constructed within 3 years, or purchased 1 year before or 2 years after the date of transfer, then exemption on the LTCG is available on the amount of investment in the new asset to the extent of the capital gains. It may be noted that the amount of capital gains not appropriated towards purchase or construction of a new house within 3 years may be deposited in the Capital Gains Account Scheme of a public sector bank before the due date of filing of Income Tax Return. This amount should subsequently be used for purchase or construction of house.

Section 54F: When the asset transferred is a long term capital asset other than a residential house and if out of the consideration, investment in purchase or construction of a residential house is made within the specified time as in sec. 54, then exemption from the capital gains will be available as:

- If cost of new asset is greater than the net consideration received, the entire capital gain is exempt.
- Otherwise, exemption = Capital Gains x Cost of new asset/ Net consideration. It may be noted that this exemption is not available, if on the date of transfer, the assessee owns any house other than the new asset.

Caution It may be noted that the Finance Act 2000 has provided that with effect from assessment year 2001–2002, the above exemption shall not be available if assessee owns more than one residential house, other than new asset, on the date of transfer. Investment in the Capital Gains Account Scheme may be made as in Sec.54.

Section 54EA: If any long term capital asset is transferred before 1.4.2000 and out of the consideration, investment in specified bonds/debentures/shares is made within 6 months of the date of transfer then exemption from capital gains is available as computed in Section 54F.

Section 54EB: If any long term capital asset is transferred before 1.4.2000 and investment in specified assets is made within a period of 6 months from the date of transfer, then exemption would be available as computed in section 54F.

Section 54EC: This section has been introduced from assessment year 2001–2002 onwards. It provides that if any long term capital asset is transferred and out of the consideration, investment in specified assets including bonds issued by National Bank for Agricultural & Rural Development or by National Highway Authority of India or by Rural Electrification Corporation is made within 6 months from the date of transfer, then exemption would be available as computed in Sec. 54F.

Section 54ED: This section has been introduced from assessment year 2002–03 onwards. It provides that if a long term capital asset, being listed securities or units, is transferred and out of the consideration, investment in acquiring equity shares forming part of an eligible issue of capital is made within six months from the date of transfer, then exemption would be available as computed in Sec. 54F.

Notes Loss under Long Term Capital Gains cannot be set off against any income under any other head but can be carried forward for 8 assessment years and be set off against capital gains in those assessments.

Tax on Short Term Capital Gain Certain Cases {Sec. 111A, applicable from the assessment year 2005–06]: Section 111A is applicable if the following conditions are satisfied:

- The taxpayer is an individual, HUF, firm, company or any other taxpayer.
- During the previous year he has generated short-term capital gain on transfer of equity shares or units in equity-oriented mutual fund.
- The transaction of transfer of such securities is entered into on a recognized stock exchange in India on or after 1.4.2004
- Such transaction is chargeable to securities transaction tax.

If the above conditions are satisfied, short-term capital gain will be taxable at the rate of 10 per cent (plus surcharge plus education cess).

Did u know? No deduction would be available under sections 80CCC to 80U from the above-noted short-term capital gains.

Where the total income as reduced by such short-term capital gains is below the maximum amount which is not chargeable to income-tax, then, such short-term capital gains shall be reduced by the amount by which the total income as so reduced falls short of the maximum amount which is not chargeable to income-tax and the tax on the balance of such short-term capital gains shall be computed at the rate of ten per cent.

Caution Exempt Income

The Finance Act 2003, has introduced S.10(33) and S.10(36) w.e.f. 01.04.2004 which provide that income arising from certain types of transfer of capital assets shall be treated as exempt income.

Section 10(33) of Income Tax Act provides for exemption of income arising from transfer of units of the US 64 (Unit scheme 1964).

Section 10(36) of Income Tax Act provides that income arising from transfer of eligible equity shares held for a period of 12 months or more shall be exempt.

The Finance Act 2004 has introduced section 10(38) of the Income Tax Act which provides that no capital gains shall arise in case of transfer of equity shares held as a long term capital asset by an individual or HUF w.e.f. 01.04.2005 provided such a transaction is chargeable to 'securities transaction tax'.

Self Assessment

State whether the following statements are true or false:

21. If cost of new asset is greater than the net consideration received, the entire capital gain is exempt.
22. If any long term capital asset is transferred before 1.4.2000 and out of the consideration, investment in specified bonds/debentures/shares is made within 6 months of the date of transfer then exemption from capital gains is available as computed in Section 54F.
23. Section 54EC has been introduced from assessment year 2002–2003 onwards.
24. Loss under Long Term Capital Gains cannot be set off against any income under any other head but can be carried forward for 8 assessment years and be set off against capital gains in those assessments.

12.7 Computation of Capital Gains in Respect of Depreciable Assets (Section 50)

Income Tax Act does not defines the term depreciation. However depreciation means a permanent delivery in the original cost of the asset due to wear and tear, constant use, new technology etc.

In Income Tax Act depreciation is provided on only four types of assets:

1. Buildings
2. Furniture
3. Machinery and plant
4. Intangible Assets

For calculating depreciation different blocks are made based on the name of asset and then the rate of depreciation, thus a block will contain only that asset which will have the same name and same depreciation.

Depreciation = (WDV of the block as on 1st April of PY + Addition to the block – Selling price of the assets sold) × Depreciation rate.

If an asset is used for less than 180 days during a P.Y. then only ½ of the depreciation will be provided on that asset.

Example: Mr. X has following assets as on 1st April 2005:

Building Categories

Assets	Rate of depreciation	W.D.V
Building -A	10%	10, 00,000
Building – B	20%	50, 00,000
Building – C	10%	12, 00,000
Plant - X	20%	24, 00,000

Following Assets were purchased during the year:

Assets	Rate of depreciation	Purchase price	Purchase/Sale Date
Building –D	10%	10, 00,000	Purchase 1/5/05
Building – F	10%	2, 00,000	Purchase 1/2/06
Plant -Y	20%	4, 00,000	Purchase 2/2/06

Following Asses were sold during the year:

Assets	Rate of depreciation	Sale Price
Building -A	10%	8, 00,000
Building – C	10%	3, 00,000
Plant - X	20%	12, 00,000

Calculate the depreciation as per income tax act.

Solution:

Particulars	Building– 10%	Building– 20%	Plant– 20%
W.D.V as on 1/4/05	22, 00,000	50, 00,000	24, 00,000
Add: Purchases before 180 days of end of year	10, 00,000	nil	nil
Add: Purchases after 180 days of end of year	2, 00,000	nil	4, 00,000
Total	34, 00,000	50, 00,000	28, 00,000
Less: Sale	11, 00,000	nil	12, 00,000
Balance	23, 00,000	50, 00,000	16, 00,000
Depreciation			
Building 10%- 2, 00,000 x 10% x ½	1, 00,000		
Building 10%- 21, 00,000 x 10%	2, 10,000		
Building 20%- 50, 00,000 x 20%		10, 00,000	
Plant 20%- nil *			nil
W.D.V as on 31/03/06	19, 90,000	40, 00,000	nil

* Depreciation on plant is not charged as there was only one plant in the block and it is sold thus physically the block cease to exist. In this case there will be a short term capital gain which will be computed as below:

Full Value of Consideration	12, 00,000

Notes

Less: Cost of Acquisition (COA)	28,00,000
Cost of Improvement (COI)	NIL
Expenditure on transfer	NIL
Short Term Capital Gains/Loss	(16,00,000)

Task Mr. X purchased a new office building for ₹ 12,00,000 on 1st June of Previous year. The opening block of building as on beginning of the previous year was ₹ 5,00,000 with rate of depreciation of 10%. During the year an old building costing ₹ 7,00,000 was sold for ₹ 2,00,000. Find out the depreciation chargeable and the amount of capital gain if any.

Special Provisions for Computation of Capital Gains in Case of Slump Sale

Any profits or gains arising from the slump sale, affected in the previous year, shall be chargeable to income-tax as capital gains arising from the transfer of long-term capital assets and shall be deemed to be the income of the previous year in which the transfer took place. However, if the undertaking is owned and held by the assessee for not more than 36 months immediately preceding the date of transfer, then such slump sale will result into short-term capital gain. On the other hand, if such undertaking is owned and held by the assessee for more than 36 months immediately preceding the date of transfer, it shall be deemed to be long-term capital gains irrespective of the fact that such undertaking has acquired certain assets which are held for less than 36 months.

Did u know? 'Slump sale' means the transfer of one or more undertakings as a result of the sale for a lump sum consideration without values being assigned to the individual assets and liabilities in such sales. In other words it is a sale where the assessee transfers one or more undertaking as a whole including all the assets and liabilities as a going concern. The consideration is fixed for the whole undertaking and received by the transferor it is not fixed for each of the asset of the undertaking as a whole by way of such sale.

Thus it may be noted that the undertaking as a whole or the division transferred shall be a capital asset.

Reference to Valuation Officer

With a view to ascertaining the fair market value of a capital asset, the concerned Assessing Officer may refer the valuation of the capital asset to a Valuation Officer appointed by the Income-tax Department in the following cases:

(a) Where the value of the asset as claimed by the assessee is in accordance with the estimate made by a registered valuer (who works in a private capacity under a licence issued by the Board and his valuation is not binding on the Assessing Officer), but the Assessing Officer is of the opinion that the value so claimed is less than its fair market value (upto June 30, 2012) w.e.f 1st July 2012, the Assessing Officer is enabled to make a reference to the Valuation Officer where in his opinion the value declared by the assessee is at variance from the fair market value [Section 55A(a)].

(b) Where the Assessing Officer is of the opinion that the fair market value of the asset exceeds the value of the asset by more than 25,000 or 15 per cent of the value claimed by the assessee whichever is less [Section 55A(b)(i) read with Rule 111AA].

(c) Where the Assessing Officer is of the opinion that, having regard to the nature of an asset and relevant circumstances, it is necessary so to make a reference to the Valuation Officer [Section 55A(b)(ii)].

It may be noted that in a case where the assessee has opted for substitution of the cost of acquisition of an asset by its fair market value as on 1.4.1981, the fair market value as claimed by him may be higher than its actual fair market value. The provisions of Section 55A(a) and (b)(i) are, therefore, not applicable to such a case. It is, however, open to the Assessing Officer to make a reference to the Valuation Officer under Section 55A(b)(ii). The Central Government has appointed a large number of Valuation Officers under Section 12A of the Wealth-tax Act and these Valuation Officers exercise their functions in relation to the categories of asset for which they have been appointed. The jurisdiction of the Valuation Officers has been defined in Rule 3A of the Wealth-tax Rules. The Valuation Officer exercises the same jurisdiction for income tax purposes also.

Caution Note that in cases covered by Section 55A (a) and (b)(i) above it is the duty of the Assessing Officer to refer the valuation of the capital asset in question to the Valuation Officer attached to the department and not to decide the question of the valuation on his own.

Example: A has the following incomes for the previous year 2012–13:

Business income (viz. business loss of 30,000)	(–) 30,000
Short-term capital gains	6,000
Long-term capital gains	1, 90,000
A deposit in public provident fund account	9,000

You are required to find out his tax liability for the assessment year 2013–14.

Solution:

Computation of net Income of Mr. A for the assessment year 2013–14

Business Income		(–) 30,000
Capital gain		
Short-term	6,000	
Long-term	1, 90,000	1, 96,000
		1, 66,000

Computation of Tax Liability for the assessment year 2013–14	Income other Long-term than long-term capital gain	Long-term capital gain
	₹	₹
Net Income (a)	(–) 24,000	1, 90,000
Tax on (a)	Nil	2,060

Notes

1. If the net income (other than long-term capital gain) is below the amount of first slab which is not taxable (i.e. 2, 00,000), then the long-term capital gain is to be reduced by the amount by which the total income (other than long-term capital gain) falls short of the maximum amount which is not chargeable tax.
2. In this case, net income (other than long-term capital gain is (–) 24,000 which will be allowed for carried forward i.e. not to be deducted from 2, 00,000. Therefore, long-term capital gain shall be reduced by 2, 00,000. Thus, no tax shall be leviable on long-term capital gain.

Self Assessment

Fill in the blanks:

25. Income Tax Act does not defines the term …………………….
26. For calculating depreciation different ………………………are made based on the name of asset and then the rate of depreciation.
27. If an asset is used for less than ……………………… during a P.Y. then only ½ of the depreciation will be provided on that asset.
28. Any profits or gains arising from the slump sale, affected in the previous year, shall be chargeable to income-tax as capital gains arising from the transfer of …………………………

Case Study

Sunderdas Haridas vs Assistant Commissioner of IT

The issue raised in Sunderdas Haridas vs Assistant Commissioner of IT relates to the rate at which the short-term capital gains of ₹ 1,00,250 which was to be taxed under the provisions of section 115E of the IT Act. It is not disputed that the assessee is a non-resident Indian to whom the provisions of Chapter XIIA of the IT Act apply. It is also not disputed that the assets in question in respect of which the short-term capital gain of ₹ 1,00,250 was derived are of the nature of specified assets mentioned in section 115C of the IT Act. For understanding the issue raised in this appeal it will be worthwhile to reproduce the relevant provisions of section 115C, 115D and 115E of the IT Act.

Section 115D reads as follows:

"115D. (1) No deduction in respect of any expenditure or allowance shall be allowed under any provision of this Act in computing the investment income of a non-resident Indian;

(2) Where in the case of an assessee, being a non-resident Indian:

(a) the gross total income consists only of investment income or income by way of long-term capital gains or both, no deduction shall be allowed to the assessee under Chapter VI-A;

(b) the gross total income includes any income referred to in clause (a), the gross total income shall be reduced by the amount of such income and the deductions under Chapter

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VI-A shall be allowed as if the gross total income as so reduced were the gross total income of the assessee."

Section 115E reads as follows:

"115E. (1) Where the total income of an assessee, being a non-resident Indian, consists only of investment income or income by way of long-term capital gains or both, the tax payable by him on his total income shall be the amount of income-tax calculated on such total income at the rate of twenty per cent of such income.

(2) Where the total income of an assessee being a non-resident Indian includes any income of the nature referred to in sub-section (1), the tax payable by him on his total income shall be:

(i) the income-tax payable by him in accordance with the provisions of sub-section (1) on income of the nature referred to in that sub-section included in the total income; plus

(ii) the amount of income-tax chargeable on the total income as reduced by the amount of income of the nature referred to in sub-section (1), had the total income so reduced been his total income."

The assessee claimed that the short-term capital gain of ₹ 1,00,250 claimed by the assessee is of the nature of investment income as defined under section 115C and so accordingly, should be taxed at the concessional tax rate of 20% stipulated in section 115E. The Assessing Officer rejected the claim on the ground that the concessional tax rate of 20% stipulated in section 115E applied only to long-term capital gains and investment income which according to the Assessing Officer did not include short term capital gains. Before the CIT(A) the assessee relied in support of its claim on the decision of the Tribunal, Delhi Bench in the case of Smt. Trishla Jain v. Dy. CIT [1990] 34 ITD 523. In this decision the Tribunal took the view that the surplus realised on the sale of capital assets is also income derived from the assets. For this view, the Tribunal relied upon the decision of the Apex Court in the case of Sevantilal Maneklal Sheth v. CIT [1968] 68 ITR 503 (SC) and also the decision of the Hon'ble Bombay High Court in the case of Manubhai A. Sheth v. N. D. Nirgudkar Second ITO [1981] 128 ITR 87. The CIT(A) rejected the claim on the ground that the specific reference to the long-capital gains in section 115E precluded, by implication, the application of the concessional tax rate to short-term capital gains. In support of his view that the "investment income" referred to in section 115E did not include short-term capital gains as contended by the assessee, he relied upon the following decisions:

(i) CIT v. B. S. Rajendrappa [1986] 162 ITR 666/27 Taxman 460 (Kar.);

(ii) CIT v. T. K. Sarala Devi [1987] 167 ITR 136/32 Taxman 451 (Ker.);

(iii) Ambalal Maganlal v. Union of India [1975] 98 ITR 237 (Guj.).

The above decisions take a view contrary to the view taken by the Hon'ble Bombay High Court in the case of Manubhai A. Sheth (supra) and held that when a capital asset is sold what is realised is capital receipt assessable to capital gains and not a revenue receipt. Before us the learned counsel for the assessee relied upon the decision of the Delhi Bench of the Tribunal cited supra and contended that the expression "investment income" used in section 115E includes short-term capital gains as the income derived on a sale of asset is also income and in this context he has also relied upon the ratio of the decision of the Bombay High Court in the case of Manubhai A. Sheth (supra) and also the decision of the Apex Court in the case of Sevantilal Maneklal Seth cited supra, on which the Delhi Bench of the Tribunal itself has relied.

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The learned departmental representative on the other hand pleaded that the concessional rate is applicable only for income in its normal sense of the term like dividend interest, on securities and long term capital gains and not for short term capital gains for the simple reason that the short-term capital gain represents "hot money" and the purpose of the Legislation is to discourage the out-flow of such hot money coming from abroad. Countering the argument of the learned counsel for the assessee that in case of ambiguity in a provision an interpretation favourable to the assessee is to be given, the learned dept. representative pointed out that such a beneficial interpretation has to be given only there is an ambiguity but an ambiguity cannot be presumed and when on a plain reading of the statutory provision the Court is of the opinion that one and only one interpretation is reasonably possible which is against the assessee, it cannot give an erroneous interpretation in favour of the assessee by resorting to the principle of beneficial construction. In this context he relied upon the decision of the jurisdictional High Court in the case of Oudh Sugar Mills Ltd. v. CIT [1996] 222 ITR 726/89 Taxman 590 (Bom.).

We are of the view that we have to uphold the contention of the learned dept. representative even though the decision of the Tribunal of Delhi Bench cited supra is in favour of the assessee. We have given our anxious consideration to the issue on hand. We are also aware that the Tribunal should be very wary of coming to a conclusion different from the one arrived at earlier whether by the same Bench or by a different Bench. The main plank of the decision of the Delhi Bench Tribunal is the decision of the Apex Court in the case of Sevantilal Maneklal Sheth (supra) in which it was held that the surplus realised on the sale of an asset is also income. So, it is necessary to consider this decision in detail and to consider whether this decision leads to the construction sought to be placed by the appellant on the scope of section 115E. This decision of the Apex Court was given in the context of interpreting the provisions of section 16(3)(a)(iii) of the Income-tax Act, 1922 which corresponds to section 64(iv) of the Income-tax Act, 1961. The issue considered was whether when assets were transferred by husband to wife the capital gains derived by wife by selling the assets could be construed as income arising directly or indirectly from assets transferred so as to attract the clubbing provisions of section 16(3)(a)(iii) of the 1922 Act. The relevant portion of the head-note of this decision reads as follows:

"The inclusion of "capital gains" in the definition of "income" was for the first time enacted in 1947. It is true that at the time when section 16(3)(a)(iii) of the Indian Income-tax Act, 1922 was enacted, the definition of "income" did not include "capital gains" but capital gains having been brought within the meaning of "income" in section 2(6C) the expression "income" as used in section 16(3)(a)(iii) must be construed according to the amended definition of the word and would, therefore, include capital gains. There is nothing in the context or language of section 16(3)(a)(iii) of the Act to suggest that capital gains are excluded from its scope.

Held, accordingly, that the capital gains derived by the wife of the assessee by the sale of assets transferred to her by him had to be included in the total income of the assessee under section 16(3)(a)(iii) of the Indian Income-tax Act, 1922.

There is no reason why a restricted interpretation should be given to the provisions of section 16(3)(a)(iii). The object of the section is to prevent avoidance of tax or reducing the incidence of tax on the part of the assessee by transfer of his assets to his wife or minor child. It is a sound rule of interpretation that statute should be so constructed as to prevent the mischief and to advance the remedy according to the true intention of the makers of the statute."

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Two observations of the Apex Court in the above decision are noteworthy. Firstly, it observed that the definition of income in the 1922 Act did not originally include capital gains. It is only by an artificial and extended definition of the word "income" that capital gains have been brought under the purview of the Income-tax statute. In this context reference can also be made to the decision of the Apex Court in the case of Navinchandra Mafatlal v. CIT [1954] 26 ITR 758 given in the context of interpreting the word "income" in entry No. 54 in List-I of the Seventh Schedule to the Government of India Act, 1935. The Court held that the word should be given the widest connotation in view of the fact that it occurred in a Legislative head conferring the legislative power and that in that context it did not bear the same meaning as was ascribed to it in cases decided under the Income-tax statute but included capital gains. The next observation of the Apex Court made in the case of Sevantilal Maneklal Sheth (supra) that is note-worthy is that it is a sound rule of interpretation that statute should be as construed as to prevent the mischief and to advance the remedy according to the true intention of the makers of the statute. It is also to be noticed that while interpreting a statute the expression used should be given due importance and no part of the expression is rendered otiose. In this context the remarks of the Apex Court in the case of Padmaraje R. Kadambande [1992] 195 ITR 877 also deserved to be kept in mind.

The Court observed that, "a statute cannot always be construed with the dictionary in one hand and the statute in the other. Regard must also be had to the scheme, context and – as in this case – to the legislative history of the provision." Keeping this observation of the Apex Court in mind we are of the view that, notwithstanding the decision of the Delhi Bench of Tribunal cited supra, the word "investment income" used in section 115E does not include within its scope short-term capital gains. If this word is so construed as to include short-term capital gains within its scope the expression "income by way of long term capital gains or both" figuring in sections 115D and 115E would be rendered otiose. Income derived from an asset can be only of two types i.e., either income as normally construed or capital gains.

The Act has consistently made a distinction between the short-term capital gains and long-term capital gains, both for applying the tax rates and set off of losses. If the benefit of the concessional tax rate is extended even to short-term capital gains by including the short-term capital gains within the scope of the expression "investment income" used in section 115E such an approach would overlook the distinction consistently made in the Act between the short-term capital gains and long-term capital gains and also, as already observed, render the expression "long-term capital gains or both redundant". In other words, if normal income and both the types of capital gains i.e., short-term and long-term are to be given benefit of concessional tax rate, the legislature could have stopped with using the expression 'investment income' in section 115E. It specifically restricted the concessional tax rate to long-term capital gains presumably with a specific purpose and that purpose appears to be the one mentioned by the learned D.R., i.e., to restrict the outflow of foreign exchange relatable to "hot money". In other words, the benefit of concessional tax rate is extended only if a trader or investor is dedicated to the Indian market for a sufficiently long time and derives either income like dividends, interest on securities or derives long-term capital gains. The exclusion of short-term capital gains is to prevent short-term or speculative inflows and out-flows of foreign exchange.

We may also refer to the provisions of section 204 the relevant portion of which reads as follows:

For the purposes of this section:

(a) "non-resident Indian" and "foreign exchange asset" shall have the meanings assigned to them in Chapter XII-A;"

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Clause (iia) of section 204 was inserted w.e.f. 1-6-1986 by Finance Act, 1986. The Reserve Bank of India has given an elaborate circular dated 11-2-1987 for the computation of long-term capital gains of an non-resident Indian for enabling the Banks or Foreign Exchange dealers to deduct tax at source as required under clause (iia) of section 204 of the IT Act and a copy of the circular may be seen at page - 5126, Vol. V, 8th Edition of Sampat Iyengar. It is to be noticed that only in respect of long-term capital gains the authorised dealer is made responsible for TDS which as evident from the said circular of the Reserve Bank of India is to facilitate the remittances of the sale proceeds of the foreign exchange assets from India. It is to be noted that such a facility is extended only to consideration in respect of long term capital assets. If short-term capital gains are also to be taxed at the same rate as applicable to the long-term capital gains, no meaningful purpose is served by restricting the facility of easy remittance of sale proceeds only to long-term capital gains as is done under section 204.

Part-II of the First Schedule to the relevant Finance Act stipulates the rates at which the tax is to be deducted at source from income subject to such deduction under the provisions of sections 193 to 195 of the IT Act. The provisions of Chapter XII-A which related to the incomes of non-residents were introduced by Finance Act, 1983 w.e.f. 1-6-1983 and Part-II of the Finance Act, 1983 stipulated that in the case of a non-resident Indian the tax should be deducted @ 20% on investment income and long-term capital gains and on other income other than interest on tax-free securities at 30%. In other words, the scheme for deducting tax at source has made a specific distinction between the rates applicable for investment income and long-term capital gains on one hand and other income (other than interest on tax-free Securities) on the other. If the same rate is applicable for (a) investment income other than capital gains, (b) long-term capital gains and (c) short-term capital gains there was no point for specifying the rate applicable at 20% only to investment income and long-term capital gains. In other words, the same rate of 20% could have been made applicable to simply what could be described as “investment income” as, this covers, if the claim advanced by the appellant is to be accepted, both normal income and income by way of capital gains, both short-term and long-term. As the legislature has taken pains to make the concessional rate of 20% applicable only for investment income and long-term capital gains both in the provisions relating to the deduction of tax at source and section 115E, we have to take the view that investment income does not include short-term capital gains for the purpose of levy of tax under section 115E. The Delhi Bench of the Tribunal did not consider the scheme of the Act particularly the provisions relating to deduction of tax at source which we have considered above. Had these provisions been specifically brought to the notice of the Hon’ble Members of the Tribunal we are of the view that the decision of the Bench would have been different from what it was.

We also find that the decision of the Hon’ble Bombay High Court in the case of Manubhai A. Sheth (supra) relied upon by the Tribunal Bombay Bench and also before us by the learned counsel for the assessee is distinguishable inasmuch as the decision was given in the context of interpreting entry No. 82 in List-I of the Second Schedule of the Constitution and their Lordships of the Bombay High Court were not considering a provision which specifically extended the benefit of concessional tax rate to only one type of capital gains as done under section 115E of the IT Act.

For the above reasons we are of the view that the benefit of concessional tax rate under section 115E cannot be extended to short-term capital gains. We also find support from the method of interpretation adopted by us in the decision of the Hon’ble Andhra Pradesh High Court in the case of M. Krishna Murthy v. CIT [1985] 152 ITR 163/23 Taxman 126. The question there considered was whether amount received on leave encashment was includible in salary for the purpose of levy of tax. While holding that the amount received

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Notes

by way of leave encashment is only a compensation or reward for services rendered by the employee and so is taxable under the head "salary". Their Lordships at page-174 of the judgment observed as follows:

"Further, there is internal evidence furnished by section 17(3)(ii) providing a clue to the intention of the Legislature as to whether payments by way of leave encashment should be regarded as "profits in lieu of salary" and consequently, as "income". It may be seen that as and when clauses (10A), (10B), (11), (12) and (13A) were inserted into section 10 by successive amendments, section 17(3)(ii) was contemporaneously and, consequently, amended so as to introduce them into the parenthetical clause therein. It is significant that when clause (10AA) which provides for exemption of encashment of leave on retirement from service from inclusion in the assessee's total income, was inserted into section 10 to be effective from April 1, 1978, by the Finance Act, 1982, no consequential amendment of section 17(3)(ii) was made. That demonstrates the intention of Parliament to the effect that all categories of payment by way of leave encashment should be treated as profit in lieu of salary and, consequently, as income. But, one particular category, viz., leave encashment paid on retirement from service, though of income character, should not be included in one's total income."

It may be observed that their Lordships held that the amount received on leave encashment during service is not exempt from tax as what is exempted under section 10AA was only encashment of leave on retirement from service. In other words, when the provision specifically exempted amount received on encashment of leave on retirement it has to be inferred that the amount received on encashment of leave prior to retirement is not exempt. On analogous reasoning we are of the view that as section 115E extends the concessional tax rate specifically and only to long term capital gains, as a corollary it follows that short-term capital gains are excluded. If such benefit is to be extended to short-term capital gains also by what we may be permitted to call, back door method through their inclusion in the scope of 'investment income' has sought to be made out to the assessee by the appellant it would, to our mind, only frustrate the intention of the Legislature.

As we have already mentioned, the scheme of the Act particularly in respect of TDS as applicable to non-resident Indians was not brought to the notice of the Delhi Bench of the Tribunal when they decided the case considered supra. Accordingly, we are of the view that the Material provisions of the Act were not considered by the Bench and if they have been considered the decision of the Tribunal would have been different. As this material internal evidence of the Act was not considered by the Delhi Bench of the Tribunal, with respect we are unable to follow the decision.

We have indicated hereinbefore that the decision of the Apex Court in the case of Sevantilal Maneklal Sheth (supra) on which the Delhi Bench of the Tribunal mainly relied was given in a different context and the Court came to the conclusion it did because there was nothing in the concerned provision to hold that capital gains were excluded from the scope of the word "income". We have brought out that in the context of section 115E and other provisions of Chapter XIIA such is not the case at all. The same is the position with the decision of the jurisdictional High Court in the case of Manubhai A. Sheth (supra) on which also same reliance was placed. This decision was given in the context of interpreting a constitutional provision relating to legislative competence and so to our mind is distinguishable. We have also invited attention to the comments of the Apex Court both in the case of Sevantilal Maneklal Sheth (supra) and Padmaraje R. Kadambande (supra) to the effect that a provision in a statute has to be interpreted in the light of its purpose and the scheme of the statute. Bearing in mind the purpose of section 115E which seems to be

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to discourage out-flows of "hot moneys" and the scheme of the Act, particularly, concerned provisions relating to deduction of tax at source and the mode of interpretation adopted by the Hon'ble Andhra Pradesh High Court in the case of M. Krishna Murthy (supra). We hold that the expression "investment income" mentioned in section 115E does not include short-term capital gains and as such, the assessee is not entitled to concessional tax rate in respect of short-term capital gains.

In the result, the assessee's appeal is dismissed.

Shri Vimal Gandhi, Vice-President

1. My brother, learned Accountant Member, was good enough to put up the proposed order without signature for my consideration. In my view, a departure from the earlier view of the ITAT Delhi Bench was not justified on mere reference to provisions relating to deduction of "tax at source" and the issue requires consideration of definition of 'investment income'. Accordingly I suggested changes to my brother on above lines. My learned brother then advised me to incorporate my suggestions in a separate note annexed to the order. In the above background, I give my reasons for agreeing with the proposed view of my learned brother.

2. The question whether short term capital gain is entitled to concessional rate of tax as stipulated in section 115E has to be determined with reference to definition of "investment income" under Chapter XII-A of the I.T. Act. The said definition is given in clause (c) of section 115C and is as under:

   "investment income" means any income derived from a foreign exchange asset;

   "Long-term capital gains" is separately defined and is stated to be one which is not arising from a short-term capital asset. The important word in the definition of 'investment income' is "any income derived from a foreign exchange asset". What is import of expression "income derived from"?

   In the case of Smt. Trishla Jain (supra), the Hon'ble Members of ITAT Delhi Bench 'E' held that the above definition of investment income would cover short-term capital gain. For reaching this conclusion, the learned Members took into account certain decisions given in relation to taxability of capital gain on transfer of agriculture land under section 45 of the I.T. Act. Certain High Courts have held that such income is not liable to be taxed. These decisions are relevant as in the definition of "agricultural income" given under section 2(1A) of the I.T. Act, any rent or revenue derived from land or any income derived from such land is included in "agricultural income". Thus in the above decision the import of word "income derived from" was considered. The learned Members also referred to the decision of Hon'ble Supreme Court in the case of Sevantilal Maneklal Sheth (supra). I shall be referring to the above decision. But before that I would like to refer to certain history of Legislation which is relevant to appreciate the point.

3. Capital gain was not included in the definition of term "income" in the Indian Income-tax Act, 1922 prior to amendment of section 2(6C) and insertion of new section 12B relating to capital gains the above was done under Entry 54 in List I of the Seventh Schedule of the Government of India Act, 1935. This entry with which definition of "income" was challenged before the Constitutional Bench of Supreme Court in the case of Navinchandra Mafatlal (supra). Their Lordships upheld the validity of amendment and held that capital gains after amendment were taxable "income".

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4. In the case of Manubhai A. Sheth (supra) the Hon'ble Bombay High Court held that amendment made to charge capital gain on transfer of agricultural land was not valid/approved and noted the change in the definition of "income" in the following words:

   "The sale price received on the sale of capital asset would be capital receipt. This is, however, a wholly different thing from saying that the profits or gains arising from the sale of a capital asset are a capital receipt. Such profits or gains are income. Not only clause (24) of section 2 of the 1961 Act, which defines the word "income", by sub-clause (vi) includes "any capital gains chargeable under section 45" within the meaning of the word "income", but the Supreme Court also has in Navinchandra's case [1954] 26 ITR 758, held such capital gains to be income. It is also pertinent to bear in mind that under the proviso to sub-section (3) of section 10 of the 1961 Act capital gains chargeable under the provisions of section 45 are expressly excluded from receipts which are of a casual and a non-recurring nature. Thus, capital gains statutorily are of recurring nature. In view of these statutory provisions and in view of the judgment of the Supreme Court in Navinchandra's case [1954] 26 ITR 758, it is not open to the respondents to argue that capital gains are capital receipt and not a revenue receipt."

5. In the case of Ambalal Maganlal (supra) their Lordships of Gujarat High Court took a view different one from that was taken by Bombay High Court and held that capital gain on sale of agricultural land was taxable income. Their Lordships made the following observation:

   "After the decision of the Supreme Court in Navinchandra Mafatlal v. CIT [1954] 26 ITR 758, it is obvious that Parliament has, by virtue of entry 82 in List I of the Seventh Schedule, the power to enact a law relating to tax on capital gains and, therefore, also to amend the law relating to tax on capital gains since such a tax would be a tax on income. It is also clear that by amending the appropriate definition in any enactment relating to Indian Income-tax, Parliament has the power to define what is meant by "agricultural income" and, by virtue of entry 82, it has power to levy tax on income other than agricultural income as thus defined. Under these circumstances, it was competent to Parliament to enact section 2(14)(iii) so as to provide for tax on capital gains arising from agricultural lands which are under consideration in the present case."

6. In the case of T. K. Sarala Devi (supra) where the leading decision taking a view contrary to that of Bombay High Court in Manubhai A. Sheth's case (supra) were considered, their Lordships of Kerala High Court observed as under:

   "The profits or gains arising from the sale of land used for agricultural purposes constitute income because section 2(24) of the Income-tax Act, 1961, includes as "income" capital gains chargeable under section 45. Such gain is not income derived from land but is income derived from the sale of the land. Although land is the source of the income, income is derived not by the use of the land, but by the sale of the land, that is, by conversion of the land into cash and if income results from the sale of the agricultural land, it is not agricultural income within the meaning of section 2(1)."

7. In the case of Sevantilal Maneklal Sheth (supra) their Lordship of Hon'ble Supreme Court while considering the question of taxability of capital gain derived by wife on assets transferred by the assessee's husband based its decision on amendment of definition of "income" made in section 2(6C) in 1947. Their Lordship observed as under:

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"The inclusion of "capital gains" in the definition of "income" was for the first time enacted in 1947. It is true that, at the time when section 16(3)(a)(iii) was enacted, the definition of "income" did not include "capital gains" but capital gains having been brought within the meaning of "income" in section 2(6C), the expression "income" as used in section 16(3)(a)(iii) must be construed according to the amended definition of the word and would, therefore, include capital gains. There is nothing in the context or language of section 16(3)(a)(iii) of the Act to suggest that capital gains are excluded from its scope. We see no reason why a restricted interpretation should be given to the provisions of section 16(3)(a)(iii) as contended for the appellant. On the contrary, the object of the enactment of the section is to prevent avoidance of tax or reducing the incidence of tax on the part of the assessee by transfer of his assets to his wife or minor child."

8. In the case of Cambay Electric Supply Industrial Co. Ltd. v. CIT [1978] 113 ITR 84 their Lordship of Hon'ble Supreme Court has observed as under:

"As regards the aspect emerging from the expression "attributable to" occurring in the phrase "profits and gains attributable to the business of" the specified industry (here generation and distribution of electricity) on which the learned Solicitor-General relied, it will be pertinent to observe that the legislature has deliberately used the expression "attributable to" and not the expression "derived from". It cannot be disputed that the expression "attributable to" is certainly wider in import than the expression "derived from". Had the expression "derived from" been used, it could have with some force been contended that a balancing charge arising from the sale of old machinery and buildings cannot be regarded as profits and gains derived from the conduct of the business of generation and distribution of electricity. In this connection, it may be pointed out that whenever the legislature wanted to give a restricted meaning in the manner suggested by the learned Solicitor-General, it has used the expression "derived from", as, for instance, in section 80J."

9. It is, therefore, clear from the above that "income derived from any asset" must have a direct nexus and should flow from the use of the asset. A profit or gain arising on the sale of an asset is not "income". It is a capital realisation. On account of amendment of the term since 1947, "capital gains" has been included in "income" and brought to tax. This has been emphasised almost by all High Courts and the Supreme Court in the above cited decisions. Even the Bombay High Court in the case of Manubhai A. Sheth (supra) also took similar view. It, therefore, follows that capital gains is "income" because it is provided in the Statutory provision. Otherwise, it is not "income". It is certainly not "income derived" from a capital asset on its transfer as in transfer the capital is realised. Thus the expression "income derived" has acquired a definite and restricted meaning. It is consciously used by the legislature as emphasised by the Supreme Court in the case of Cambay Electric Supply Industrial Co. Ltd. (supra) and other decisions. Having regard to the above discussion "investment income" which means income derived from foreign exchange asset cannot include capital gain arising on transfer of foreign exchange asset for purposes of Chapter XII-A of the I.T. Act. Realisation of capital through transfer of capital asset cannot be income derived from the asset. For this reason legislature separately defined long term capital gain and made specific provision to give it a beneficial treatment. As stated earlier long term capital gain is defined as one which is not short term capital gain. It is, therefore, clear that legislature did not intend to give benefit to short term capital gains although short term capital gains for the purposes of Income-tax Act remained part of "total income" within the meaning of section

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Notes

2(45) of the Act. The above view is the only view which emerges from authoritative pronouncements of different High Courts and the Supreme Court. Having regard to the observation of different Courts, I agree with my learned brother that there is good ground for not following the decision of Delhi Bench of ITAT.

10. For the above reasons I agree with my learned brother and hold that short term capital gain is not entitled to concessional rate applicable under section 115-E of the I.T. Act. I also agree with the other part of the proposed order of my learned brother. The appeal of the assessee is dismissed.

Questions

1. Study and analyse the case.
2. Write down the case facts.
3. What do you infer from it?

Source: http://www.indiankanoon.org/doc/11120/

12.8 Summary

- Under the Income Tax Act, any profits or gains arising from the transfer of a capital asset effected in the previous year, shall be chargeable to income tax under the head 'capital gains' and shall deemed to be the income of the previous year in which the transfer took place unless such capital gain is exempted under the prescribed exemptions.
- 'Capital gains' means any profit or gains arising from transfer of a capital asset. If any Capital Asset is sold or transferred, the profits arising out of such sale are taxable as capital gains in the year in which the transfer takes place. Capital gains are the difference between the price at which the capital asset was acquired and the price at which the same asset was sold. In technical terms, capital gain is the difference between the cost of acquisition and the fair market value on the date of sale or transfer of asset.
- Under the existing provisions of Section 2(14), a 'capital asset' means, property of any kind held for personal use by the assessee, whether or not connected with his business or profession, personal effects held for personal use by the assessee or any number of his family dependent on him are excluded from the ambit of the definition of capital asset. The only asset that is in the nature of personal effects, but is included in the definition of capital asset is jewellery and ornaments.
- However, with effect from assessment year 2008–09, archaeological collections, drawings, paintings, sculptures or any work of art have also been excluded from the meaning of personal effects and transfer of such personal effects will also attract capital gains tax. Capital Assets are of two types i.e., long term and short term. A capital asset held for 36 months or less before it is sold or transferred.is called as a short-term capital asset and if the period exceeds 36 months, the asset is known as a long-term capital asset. In case of shares, debentures and mutual fund units the period of holding required is only 12 months.
- Transfer of a short term capital asset gives rise to "Short Term Capital Gains" (STCG) and transfer of a long capital asset gives rise to "Long Term Capital Gains" (LTCG). Different rates of tax apply for gains on transfer of the long term and short-term capital assets. Gains on short-term capital asset are taxed as regular income.
- The word transfer under income tax act is defined under section 2(47). As per section 2 (47) Transfer, in relation to a capital asset, includes sale, exchange or relinquishment of the asset or extinguishments of any right therein or the compulsory acquisition thereof under any law.

- Cost of Acquisition (COA) means any capital expense at the time of acquiring capital asset under transfer, i.e., to include the purchase price, expenses incurred up to acquiring date in the form of registration, storage etc. expenses incurred on completing transfer.
- Cost of improvement is the capital expenditure incurred by an assessee for making any addition or improvement in the capital asset. It also includes any expenditure incurred in protecting or curing the title. In other words, cost of improvement includes all those expenditures, which are incurred to increase the value of the capital asset.
- Income Tax Act does not defines the term depreciation. However depreciation means a permanent delivery in the original cost of the asset due to wear and tear, constant use, new technology etc.

12.9 Keywords

Assessing Officer: It means the Income-Tax Officer or Assistant Commissioner of Income-Tax or Deputy Commissioner of Income-Tax or Joint Commissioner of Income-Tax or Additional Commissioner of Income-Tax who is authorized by the Board to exercise or perform all or any of the powers and functions conferred on, or assigned to an AO under the Income tax Act, 1961.

Capital Asset: It is an asset that has a useful life longer than one year and is not intended for sale during the normal course of business.

Capital Gain: It means any profit or gains arising from transfer of a capital asset.

Cost of Acquisition (COA): It means any capital expense at the time of acquiring capital asset under transfer, i.e., to include the purchase price, expenses incurred up to acquiring date in the form of registration, storage etc. expenses incurred on completing transfer.

Cost of Improvement: It is the capital expenditure incurred by an assessee for making any addition or improvement in the capital asset.

Depreciation: A method of allocating the cost of a tangible asset over its useful life.

Long Term Capital Assets (LTCA): An asset, which is held by an assessee for 36 months or more, immediately before its transfer, is called Long Term Capital Assets.

LTCG: The profit on transfer of Long Term Capital Assets is treated as Long Term Capital Gains (LTCG).

Short Term Capital Assets (STCA): An asset, which is held by an assessee for less than 36 months, immediately before its transfer, is called Short Term Capital Assets.

STCG: The profit on transfer of Short Term Capital Assets is treated as Short Term Capital Gains (STCG).

12.10 Review Questions

1. Explain how the word transfer occupies a very important place in capital gain.
2. Prepare a list of transactions which do not constitute transfer.
3. Write a short note on Zero Coupon Bonds.
4. What is Cost of Acquisition?
5. Define Cost of improvement.
6. Discuss in brief the Taxation on Long-term Capital Gains.

7. Explain using an example the Computation of capital gains in respect of depreciable assets.
8. What are 'Capital Assets'? What items are not included in capital assets?
9. Differentiate between long-term capital and short-term capital gain.
10. Mr. X purchased a house property for ₹ 80,000 on July 31, 1970. The following expenses are incurred by him for making addition to the house property:
    (a) Cost of construction of first floor in 1975–76 ₹ 1,00,000
    (b) Cost of construction of second floor in 1983–84 ₹ 2,40,000

    For market value of the property on April 1, 1981 is ₹ 4, 00,000. X sells the house property on August 20, 2004 for ₹ 30, 00,000 (expenses incurred on transfer: ₹ 10,000). Find out the capital gain chargeable to tax.

Answers: Self Assessment

1. Capital gains
2. Section 45
3. Sold or transferred
4. Capital receipt
5. True
6. False
7. True
8. True
9. Transfer
10. Section 2(47)
11. Gift or inheritance
12. Section 281
13. True
14. False
15. True
16. True
17. Cost of acquisition
18. Fair market value
19. Cost of improvement
20. 20 per cent
21. True
22. True
23. False
24. True
25. Depreciation
26. Blocks
27. 180 days
28. LTCA

12.11 Further Readings

Books

Aggarwal, K. *Direct Tax Planning and Management.* Atlantic Publications.

Ahuja, G. K. & Gupta, Ravi. *Systematic Approach to Income Tax.* Bharat Law House.

Lakhotia, R. N. *Income Tax Planning Handbook.* Vision Books.

Singhania, V. K. & Singhania, Kapil. *Direct Taxes Law & Practice.* Taxmann Publications.

Srinivas E. A. *Handbook of Corporate Tax Planning.* Tata McGraw Hill.

Notes

Online links

http://finance.indiamart.com/taxation/income_tax/tax_income_capital gains.html

http://finotax.com/itax/itinfo7.htm#i7

http://taxguru.in/income-tax/capital-gains-under-income-tax-act-1961.html

http://www.caclubindia.com/articles/notes-on-income-from-capital-gain-3308.asp

http://www.valueresearchonline.com/story/h2_storyview.asp?str=18750

Unit 13: Income from Other Sources

CONTENTS

Objectives

After studying this unit, you will be able to:

- Define the concept of Income chargeable under the head "Income from other sources"
- Discuss the Tax treatment for Dividends
- Describe the Deductions in calculating income from other sources
- Explain the concept of Tax concessions
- Trace the Assessee external to the range of tax liability in respect of Interest on Securities

Introduction

Income chargeable under Income-tax Act, which does not specifically fall for assessment under any of the heads discussed earlier, must be charged to tax as "income from other sources". This head is thus a residuary head of income under which income can be computed only after deciding whether the particular item of income is otherwise assessable under any of the first four heads. In addition to the taxation of income not covered by the other heads, Section 56(2) specifically provides certain items of incomes as being chargeable to tax under the head in every case. The provisions for computation of income from other sources are covered under Sections 56 to 59. While section 56 defines the scope of income chargeable under this head, Sections 57 and 58 specify the basis of computation of such income.

At the end of this unit, you will learn (i) which are the income chargeable under the head income from other sources, (ii) which are the incomes specifically taxable under this head, (iii) what are admissible deductions, (iv) which are the inadmissible deductions and (v) what are the provisions of taxability of gift in kind or in cash from relative or unrelated persons.

Notes

The incomes which are neither covered under the head salary, house property, business income or capital gains shall be taxable under head Income from other sources. This head of income is a residual head because it covers all other incomes which are uncovered and which are not exempt from tax.

13.1 Income Chargeable under the Head "Income from Other Sources"

Income chargeable under Income-tax Act, which does not specifically fall for assessment under any of the heads discussed earlier, must be charged to tax as "income from other sources". This head is thus a residuary head of income under which income can be computed only after deciding whether the particular item of income is otherwise assessable under any of the first four heads. In addition to the taxation of income not covered by the other heads, Section 56(2) specifically provides certain items of incomes as being chargeable to tax under the head in every case.

Such incomes are:

1. ***Dividends [Section 56(2)(i)]:*** Current profit would be part of accumulated profits but subsidiary on capital account cannot be treated as accumulated profits.

2. ***Keyman Insurance policy:*** Amount received under a Keyman insurance Policy, including bonus on each Policy, if it is not taxable under any other head of income.

3. ***Winnings from lotteries [Section 56(2)(ib)]:*** Any winnings from lotteries, crossword puzzles, races including horse races, card games and other games of any sort or from gambling or betting of any form or nature.

   Did u know? Winnings from lotteries, cross-word puzzles, races, (including horse races), card games and other games of any sort or from gambling or betting of any form or nature whatsoever, are specifically chargeable to tax as income from other sources even if the assessee deriving such income claims to carry on any trade or adventure in these activities as part of his business.

   The entire income of winnings, without any expenditure or allowance or deductions under Sections 80C to 80U, will be taxable. However, expenses relating to the activity of owning and maintaining race horses are allowable. Further, such income is taxable at a special rate of income-tax i.e., 30% + surcharge + cess @ 3%.

4. ***Contribution to Provident fund:*** Income of the nature referred to in Section 2(24)(x) (relating to certain contributions to any provident fund or superannuation fund or any fund set up under the provisions of the ESI Act or any other fund for the welfare of such employees received by the assessee from his employees in his capacity as an employer) will be chargeable to income-tax under the head "income from other sources" if such income is not chargeable to income-tax under the head "profits and gains of business or profession". But if the employer deposits such amount on or before due date of deposit applicable for such contribution, he will be allowed a deduction on account of the same.

5. ***Income by way of interest on securities:*** If the income by way of interest on securities is not chargeable to income-tax under the head 'Profits and gains of business or profession'.

6. ***Income from hiring machinery etc. [Section 56(2)(ii)]:*** Income from machinery, plant or furniture belonging to the assessee and let on hire if the income is not chargeable to income-tax under the head "profits and gains of business or profession".

7. ***Hiring out of building with machinery etc. [Section 56(2)(iii)]:*** Where an assessee lets on hire machinery, plant or furniture belonging to him and also building and the letting of the building is inseparable from the letting of the said machinery, plant or furniture, the income from such letting, if it is not chargeable to income-tax under the head "Profits and gains of business or profession".

8. ***Money Gifts:*** Where any sum of money, the aggregate value of which exceeds fifty thousand rupees, is received without consideration, by an individual or a Hindu undivided family, in any previous year from any person or persons on or after the 1st day of April, 2006 but before 1st day of October, 2009 , the whole of the aggregate value of such sum [Section 56(2)(vi)]

   Provided that this clause shall not apply to any sum of money received:

   (a) from any relative; or

   (b) on the occasion of the marriage of the individual; or

   (c) under a will or by way of inheritance; or

   (d) in contemplation of death of the payer; or

   (e) from any local authority as defined in the Explanation to clause (20) of section 10; or

   (f) from any fund or foundation or university or other educational institution or hospital or other medical institution or any trust or institution referred to in clause (23C) of section 10; or

   (g) from any trust or institution registered under section 12AA.

Caution For the purposes of this clause, relative means

(i) spouse of the individual;

(ii) brother or sister of the individual;

(iii) brother or sister of the spouse of the individual;

(iv) brother or sister of either of the parents of the individual;

(v) any lineal ascendant or descendant of the individual;

(vi) any lineal ascendant or descendant of the spouse of the individual;

(vii) spouse of the person referred to in clauses (ii) to (vi).

9. ***Gifts in Cash or in Kind:*** Where an individual or a Hindu undivided family receives, in any previous year, from any person or persons on or after the 1st day of October, 2009

   (a) any sum of money, without consideration, the aggregate value of which exceeds fifty thousand rupees, the whole of the aggregate value of such sum;

   (b) any immovable property, without consideration, the stamp duty value of which exceeds fifty thousand rupees, the stamp duty value of such property.

   (c) any property, other than immovable property

   ♦ without consideration, the aggregate fair market value of which exceeds fifty thousand rupees, the whole of the aggregate fair market value of such property;

- for a consideration which is less than the aggregate fair market value of the property by an amount exceeding fifty thousand rupees, the aggregate fair market value of such property as exceeds such consideration:

  Provided that where the stamp duty value of immovable property as referred to in sub-clause (b) is disputed by the assessee on grounds mentioned in sub-section (2) of section 50C, the Assessing Officer may refer the valuation of such property to a Valuation Officer, and the provisions of section 50C and sub-section (15) of section 155 shall, as far as may be, apply in relation to the stamp duty value of such property for the purpose of sub-clause (b) as they apply for valuation of capital asset under that section:

  Provided further that this clause shall not apply to any sum of money or any property received

- from any relative; or
- on the occasion of the marriage of the individual; or
- under a will or by way of inheritance; or
- in contemplation of death of the payer or donor, as the case may be; or
- from any local authority as defined in the Explanation to clause (20) of section 10; or
- from any fund or foundation or university or other educational institution or hospital or other medical institution or any trust or institution referred to in clause (23C) of section 10; or
- from any trust or institution registered under section 12AA.

Notes **Important Definitions**

"Fair market value" of a property, other than an immovable property, means the value determined in accordance with the method as may be prescribed;

"Property" means the following capital asset of the assessee, namely:

- immovable property being land or building or both;
- shares and securities;
- jewellery;
- archaeological collections;
- drawings;
- paintings;
- sculptures; or
- any work of art or
- bullion

"Stamp duty value" means the value adopted or assessed or assessable by any authority of the Central Government or a State Government for the purpose of payment of stamp duty in respect of an immovable property.

Notes

10. ***Shares as gift:*** Where a firm or a company not being a company in which the public are substantially interested, receives, in any previous year, from any person or persons, on or after the 1st day of June, 2010, any property, being shares of a company not being a company in which the public are substantially interested,

    (a) without consideration, the aggregate fair market value of which exceeds fifty thousand rupees, the whole of the aggregate fair market value of such property;

    (b) for a consideration which is less than the aggregate fair market value of the property by an amount exceeding fifty thousand rupees, the aggregate fair market value of such property as exceeds such consideration :

    Provided that this clause shall not apply to any such property received by way of a transaction not regarded as transfer under clause (via) or clause (vic) or clause (vicb) or clause (vid) or clause (vii) of section 47.

11. ***Share premiums in excess of the fair market value to be treated as income:*** Where a company, not being a company in which the public are substantially interested, receives, in any previous year, from any person being a resident, any consideration for issue of shares that exceeds the face value of such shares, the aggregate consideration received for such shares as exceeds the fair market value of the shares:

    Provided that this clause shall not apply where the consideration for issue of shares is received

    - by a venture capital undertaking from a venture capital company or a venture capital fund; or
    - by a company from a class or classes of persons as may be notified by the Central Government in this behalf.

Did u know? For the purposes of this clause,

(a) the fair market value of the shares shall be the value:

- as may be determined in accordance with such method as may be prescribed; or
- as may be substantiated by the company to the satisfaction of the Assessing Officer, based on the value, on the date of issue of shares, of its assets, including intangible assets being goodwill, know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, whichever is higher;

(b) "Venture capital company", "venture capital fund" and "venture capital undertaking" shall have the meanings respectively assigned to them in clause (a), clause (b) and clause (c) of Explanation 1 to clause (23FB) of section 10

12. Income by way of interest received on compensation or on enhanced compensation referred to in clause (b) of section 145A.

In addition to the above there are some other incomes which are also chargeable under the head 'Income from Other Sources'. For example:

1. Agricultural Income from land situated outside India.
2. All interest other than interest on securities, e.g. interest on bank deposits, interest on loan, etc.

Notes

3. Amount withdrawn from deposit in National Savings Scheme, 1987 on which deduction under Section 80CCA has been allowed including interest thereon.
4. Any annuity received under a Will. It does not include an annuity received by an employee from his employer.
5. Any fees or commission received by an employee from a person other than his employer.
6. Casual income in excess of ₹ 5,000, or (₹ 2,500 in case of winning from horse race, etc.) as the case may be.
7. Director's commission for giving guarantee to bank.
8. Director's commission for underwriting shares of a new company.
9. Director's fees.
10. Family pension received by the widow of an employee of the U.N.O. is exempt. Similarly the family pension of gallantry awardee is exempt.
11. Gratuity received by a director who is not an employee of the company.
12. Income from leasehold property.
13. Income from markets, ferries and fisheries, etc.
14. Income from undisclosed sources.
15. Income of a tenant from sub-letting the whole or a part of the house property.
16. Income of Royalty.
17. Interest received by an employee on his own contributions to an unrecognised provident fund.
18. Interest received on securities of co-operative society.
19. Remuneration received by a teacher or a lawyer for doing examination work.
20. Remuneration received for writing articles in Journals.
21. Rent of land not appurtenant to any building.
22. Salary of a Member of Parliament, Member of Legislative Assembly or Council.

Further, under the provisions of Section 60 to 65 an assessee may be chargeable to tax in respect of income arising to other persons, e.g. spouse or minor children. In such cases, the income in question will be first computed under the appropriate head after allowing various deductions and includible in the total income of the assessee under the head "income from other sources". In other words, wherever the assessee is taxable in respect of income of somebody else, the income must be charged to tax in the hands of the assessee only under this head even if the income is of a character which would otherwise fall for assessment under any other head of income.

Self Assessment

Fill in the blanks:

1. …………………………specifically provides certain items of incomes as being chargeable to tax under the head Income from other sources.
2. Amount received under a …………………………, including bonus on each Policy, if it is not taxable under any other head of income than is taxed under income from other sources.

3. The entire income of winnings, without any expenditure or allowance or deductions under Sections 80C to 80U, will be ………………………..

4. If the income by way of interest on securities is not chargeable to income-tax under the head …………………….than it is charged under income from other sources.

5. Where any sum of money, the aggregate value of which exceeds ……………………………, is received without consideration is taken as income from other sources.

13.2 Tax Treatment for Dividends

Section 10(34) exempts dividend (as defined in Section 115-O) from tax in the hands of recipients thereof. Section 115-O, the main operative provision in the newly introduced Chapter XII-D, however, calls upon a company declaring or distributing dividend to pay 15% plus surcharge plus Education & Secondary and Higher Education Cess by way of tax on distributed profits in addition to what it is liable by way of tax on its income in the normal course. This tax on distribution paid by a company is not available for deduction under any provision of the Act.

Dividend for the purpose of Section 115-O and by extension for the purpose of Section 10(33) is the same as defined in Section 2(22) except that clause (e) thereof shall not be treated as dividend for both these purposes.

Notes The scheme of taxation of dividend can be summarized as under:

(a) Dividends or any other income distributed by UTI or a foreign company, are chargeable to tax under this head.

(b) In respect of dividend under clause (e) of Section 2(22) the status quo continues i.e. the specified persons receiving loans and advances from a closely-held company will continue to pay tax as earlier on these receipts and the company giving such loans and advances will not be liable to tax like it was earlier. It may be pointed out that tax liability under clause (e) of Section 2(22) would be extremely unlikely now that there is no need for the dominant shareholders of closely-held companies to combine dividend with the character of loan or advance to avoid tax liability because dividend is no longer taxable in the hands of shareholders. Against this backdrop, the discussion hereunder may be studied.

13.2.1 Meaning of the Term 'Dividend' [Section 2(22)]

The term 'dividend' is ordinarily used to refer to any distribution made by a company to its shareholders out of its profits in proportion to the number of shares held by the shareholder concerned in the company. Apart from the distribution made by the company, any division of profit between the members who earned the same would also be treated as dividend under the general meaning of expression. For purposes of income-tax, the definition of dividend is given in Section 2(22) of the Income-tax Act.

The definition, although not exhaustive and comprehensive, is having the effect of over-riding anything else to the contrary contained in any other law for the time being in force. The definition given in the Income-tax Act is enumerative and inclusive in nature and does not precisely specify as to what exactly is meant by the term dividend. Consequently, any money received by a shareholder which may not fall within the various items specified in the Income-tax Act may still be considered and taxable as dividend except in cases where a different interpretation or inference could be had in the circumstances of the case.

Notes

According to the definition in the Income-tax Act, 'Dividend' includes the following items:

1. Any distribution by a company of accumulated profits, whether capitalized or not, if such distribution entails the release by the company to its shareholders of all or any part of the assets of the company; Current profit would be part of accumulated profits but subsidy on Capital Account cannot be treated as accumulated profits;

2. Any distribution, by a company to its shareholders, of debentures debenture stock or deposit certificates in any form, whether with or without interest and any distribution to its preference shareholders of shares by way of bonus to the extent to which the company possesses accumulated profits, whether capitalised or not;

3. Any distribution made to the shareholders of a company on its liquidation, to the extent to which such distribution is attributable to the accumulated profits of the company immediately before its liquidation, whether capitalized or not;

4. Any distribution to its shareholders by a company on the reduction of its share capital, to the extent to which the company possesses accumulated profits, whether capitalised or not;

5. Any payment made by a company, in which the public are not substantially interested of any sum whether representing a part of the assets of the company or otherwise made after the 31st day of May, 1987, by way of advance or loan to a shareholder, being a person who is the beneficial owner of shares, holding not less than ten per cent of the voting power, or to any concern in which such shareholder is a member or a partner and in which he has a substantial interest, or any payment by any such company on behalf of or for the benefit of the shareholder having substantial interest in the company to the extent to which the company possesses accumulated profits.

Caution Sub-section (22) to Section 2 specifically excludes the following:

1. Any distribution made by a company in accordance with (3 or (4) above in respect of any share issued for full cash consideration in cases where the shareholder is not entitled, in the event of liquidation, to participate in the surplus assets of the company;

2. Any distribution made in accordance with items (3) and (4) above in so far the distribution is attributable to the capitalised profits of the company representing bonus shares allotted to its equity shareholders after 31.3.1964 and before 1.4.1965;

3. Any advance or loan made by a company to its shareholder the said concern, i.e., a HUF firm, an AOP or, BOI or a company in the ordinary course of its business in cases where lending of money is a substantial part of the business of the company;

4. Any dividend paid by a company which is set off by the company against the whole or any part of any sum previously paid by it and treated as a dividend under item (e) above to the extent to which it is so set off;

5. Any payment made by a company on purchase of its own shares from a shareholder in accordance with the provisions of Section 77A of the Companies Act, 1956;

6. Any distribution of shares pursuant to a demerger by the resulting company to the shareholders of the demerged company.

The account given above represents various payments which are notionally or by fiction of law, treated as dividend and which, in the absence of specific provision may not be chargeable to tax as dividend income in the hands of shareholders. The distributions or payments constituting dividend referred to above apply only to payments or distributions made by a company as defined in Section 2(17) of the Income-tax Act.

Since the meaning and scope of the term 'dividend' used in the income-tax Act is much wider than what is commonly understood, it covers not only payments as dividends made by a company in accordance with the provisions of company law but also various other payments which may not amount to dividend under company law.

In order to be chargeable to tax as dividend, it is not essential that the dividend must be paid only in cash although the provisions of Company Law require that a dividend must always be paid in cash or by cheque. In all cases where a dividend is paid in any form other than cash, say in the form of goods, securities or shares, even of another company, the amount of dividend which is liable to income-tax must be taken to be the market value of the thing received as dividend.

Example: If 'A' company distributes dividends to its shareholders in the form of shares of its wholly owned subsidiary company 'B' at the face value of ₹ 100 each while the market value is ₹ 150 per share, the liability to tax on the part of the company would be on the basis of the market value of the share. For this purpose, it is immaterial if the shares are such that a part of the shares cannot be divided for being utilized towards tax deductible at source. The company's liability to pay distribution tax is not in any way affected or reduced by the fact that the dividend in question is paid in kind or is calculated on a basis different from what the income-tax law provides.

It is likely that the company may not comply with some of the provisions of Company Law in the matter of declaration and payment of dividends. Even in such cases, non-observance of the various formalities or the provisions of Company Law by the company concerned would not in any way affect the taxability of the amount as dividend in the hands of the Company. Consequently, if a company, in violation of law, distributes dividends out of its share premium account, the Company would still be taxable regardless of the fact that the payment in question does not come out of the revenue profits of the declaring company.

In the process of capitalisation of the accumulated profits and reserves, a company may normally resort to the issue of bonus shares. This is mostly done in cases when a company is prosperous and has a large surplus and after some time it is decided to convert the surplus into capital and divide the capital amongst the members in proportion to their rights. This is done by issuing fully paid shares representing the increased share capital.

Bonus shares are issued out of credit balance to the Profit and Loss Account and out of reserves and the shareholders to whom the shares are issued, have to pay nothing. The purpose is to capitalise profits which may be otherwise available for distribution. If the Articles of Association of a company permit, a company can capitalise profits and reserves and issue fully paid shares on a nominal value equal to the amount capitalised to its shareholders. This is permissible subject, however, to the provisions of Sections 78 and 205 of the Companies Act and guidelines issued in this regard by the SEBI.

When bonus shares are issued by a company to its equity shareholders the company is not chargeable to distribution tax on the value of the bonus shares. This is because of the fact that according to Section 2(22)(a), the distribution of accumulated profits of a company would result in dividend only if there is release of the company's assets as a result of such distribution. This is because of the fact that the effect of the bonus issue is that the profits remain in the hands of the company as capital and the shareholders receive only paper certificates as evidence of their interest in the additional capital so set aside or capitalised. The transaction takes nothing out of the company's coffers and puts nothing into the shareholders' pockets and the only result is that the company which, before the resolution, could have distributed the profits by way of dividend or carried it to a reserve account, comes under an obligation to retain it permanently as its capital.

Therefore, bonus shares given by a company in proportion to the holding of equity capital by a shareholder are, in the absence of any express provision to the contrary, not liable to be taxed as income. Therefore, bonus shares are not dividend or income at all when they are issued to the holders of equity or ordinary shares.

However, the utilisation of the accumulated profits for the purpose of starting a subsidiary company and issue of shares of the subsidiary company to its own shareholders as bonus shares would constitute dividend, as there would be a release of assets by the parent company.

In cases where bonus shares are issued to the holders of preference shares, the market value of the bonus shares would be liable to distribution tax as income by way of dividends in the hands of the Company in view of the specific provisions contained in Section 2(22)(b). However, even in the case of preference shareholders, the liability to tax would be only to the extent to which the distribution is made by the company out of its accumulated profits, whether capitalised or not.

Any distribution made by a company out of its accumulated profits would constitute dividend if the distribution is made on the reduction of share capital of the company. This reduction may take place even in cases where bonus shares are issued by capitalising the accumulated profits and reserves of the company and later on paying off the bonus shares. This may also take place in cases where the accumulated profits are applied first towards making the partly-paid shares into fully-paid ones and later, the amount of the fully-paid shares is reduced on reduction of share capital. Even in the case of liquidation of a company, any distribution made by the liquidator (less than the capital subscribed) would constitute income from dividend to the extent to which the distribution could be attributable to the accumulated profits of the company which may or may not have been capitalised during the existence of the company.

The ‘accumulated profits’ for the purpose do not include any capital gain arising to the company before 1.4.1946 or after 31.3.1948 and before 1.4.1956 because during these periods capital gains were not chargeable to tax and were consequently not treated as part of the profits of the company. In the case of every company, the expression accumulated profits must be taken to include all profits of the company upto the date of distribution or payment including reserves kept for specific purposes so long as such reserves constitute an appropriation of profit instead of being a charge against profit.

Example: Amount represented by the balance to the credit of the development rebate reserves account would form part of the accumulated profits of the company; but if a company follows the process of crediting the amount of depreciation reserve account such a reserve would not form part of the accumulated profits of the company because depreciation is a charge against the profits and not an appropriation of profits. In the case of a company in liquidation, accumulated profits should be taken to include all the profits of the company upto the date of liquidation. But in cases where the liquidation is consequent upon the compulsory acquisition of its undertaking by a government or a corporation owned or controlled by the government under any law for the time being in force, accumulated profits should not be taken to include any profits of the company prior to three successive accounting years immediately preceding the accounting year in which such acquisition of the company was made by the government or other statutory corporation.

Any payment of loan or other advance by a company, in which the public are not substantially interested, to its shareholder who has substantial interest in the company would constitute dividend to the extent to which the company possesses accumulated profits which may or may not have been capitalised. Similarly, any payment made by a closely held company for the individual benefit of a shareholder who has a substantial interest in the company would also constitute dividend chargeable to tax in the hands of the shareholder.

Example: If a closely held company makes payment of insurance premium on behalf of the shareholder or lends money to the shareholder or makes any advance on his behalf, the shareholder would be deemed to have received a dividend and be chargeable to income-tax thereon. The expression 'shareholder' for this purpose should be taken to mean only the registered shareholder and not the beneficial shareholder.

Consequently in cases where the loans are given by a closely held company to a Hindu Undivided Family of which the registered shareholder is a member, such loans would not be taxable as dividend since the Hindu Undivided Family is not registerable as shareholder of the company. If, however, the loans are advanced to the registered shareholders, the loans would be taxable as dividend even though the registered shareholder may not have any personal or beneficial interest in the shares concerned. The liability to tax in respect of such loans, advances, other payments made by a closely held company to its substantial shareholder, would be only to the extent to which the company possesses accumulated profits, which may or may not have been capitalised.

Notes The types of dividend contemplated by the first four clauses viz. (a) to (d) of Section 2(22) are exempt in the hands of the shareholders.

The last category viz. 2(22) (e) which has applicability only to the shareholders of closely-held companies or dividend from a foreign company, be taxable in the hands of shareholders.

Self Assessment

State whether the following statements are true or false:

6. Section 10(34) exempts dividend (as defined in Section 115-O) from tax in the hands of recipients.
7. Chapter XII-D calls upon a company declaring or distributing dividend to pay 25% plus surcharge plus Education & Secondary and Higher Education Cess.
8. Dividend for the purpose of Section 115-O and by extension for the purpose of Section 10(33) is the same as defined in Section 2(22) except that clause (e).
9. Any division of profit between the members who earned the same would also be treated as dividend.
10. Bonus shares are issued out of credit balance to the Profit and Loss Account and out of reserves and the shareholders to whom the shares are issued, have to pay nothing.

13.3 Deductions in Calculating Income from Other Sources

The income chargeable under the head "Income from other sources" is the income after making the following_deductions:

1. ***From interest on securities:*** Any reasonable sum paid by way of commission or remuneration to a banker or any other person for the purpose of realising such interest on behalf of the assessee. Interest on money borrowed for investment in securities can be claimed as a deduction.

Notes

During the previous year the assessee withdrew a fixed deposit before maturity and had to refund ₹ 3,500 to the bank. The amount withdrawn was invested in shares. It was held by Karnataka High Court under the earlier regime that the amount paid to the Bank was an expenditure laid out wholly and exclusively for the purpose of earning the dividend income and deduction thereof while computing income from dividend is in order.

2. From the contributions received by employer from employees towards P.F. or Superannuation or other funds: In the case of income of the nature referred to in Section 2(24)(x), which is chargeable to income-tax under the head "Income from other sources" deduction shall be allowable in accordance with the provisions of Section 36(1)(va), i.e., if the employer has credited the employee's accounts in the respective funds with the amounts of contributions received, the employer shall be allowed credit thereof.

3. ***Income derived from letting:*** Where income is derived from letting out of machinery, plant or furniture on hire and also buildings where the letting of building is inseparable from the letting of such machinery, plant or furniture and the income from such letting is not chargeable to Income-tax under the head "Profits and Gains of Business or profession", the following expenses incurred in respect of those assets:

    a) Current repairs of buildings.

    b) Insurance premium against risk of damage or destruction of the premises.

    c) Repairs and insurance of machinery, plant or furniture.

    d) Depreciation.

    Where the expenses referred to at (a) to (d) hereinabove are incurred on property used partly for the business of the assessee, a proportionate deduction shall be allowed.

4. ***Income in the nature of family pension:*** Where a regular monthly amount is payable by an employer to a person belonging to the family of an employee in the event of his death, i.e., 'family pension', a sum equal to 33-1/3% of the income or 15,000, whichever is less, is allowable as a deduction. All these expenses will be allowed only when the prescribed particulars are furnished by the assessee.

5. ***Interest on compensation or enhanced compensation:*** A deduction of a sum equal to 50% of such income and no deduction shall be allowed under any other clause of this section.

6. ***Other deductions:*** Any other expenditure (not being in the nature of capital expenditure) laid out or expended wholly and exclusively for the purpose of making or earning such income.

Task Prepare in a group a list of Deductions in calculating income from other sources giving suitable examples.

13.3.1 Conditions to be Satisfied for Claiming Deductions

Deductions under this clause will, therefore, be allowed only if the following conditions are satisfied:

(a) The expenditure is laid out wholly and exclusively for the purpose of earning such income. If the purpose of earning income is coupled with some other extraneous purpose, it will not be possible to say that the deduction under Section 57 (iii) is earned by the assessee.

(b) It is not in the nature of capital expenditure.

(c) It is not a personal expenditure.

(d) It is incurred in the accounting year itself and not in any prior or subsequent year.

The section does not say that the expenditure shall be deductible only if income is made or earned. Interest on moneys borrowed for investment in shares which had not yielded any income was admissible as a deduction under the section.

Notes In computing the income by way of dividends of a foreign company, no deduction will be allowed under Section 57.

13.3.2 Amounts not Deductible (Section 58)

The following amounts shall not be deducted in computing income chargeable under the head 'Income from other sources':

In the case of any assessee:

1. Any personal expenses of the assessee.

2. Any interest chargeable under the Income-tax Act which is payable outside India and from which income tax has not been paid or deducted at source.

3. Any payment which is chargeable under the head "Salaries" if it is payable outside India unless tax has been paid thereon or deducted therefrom at source.

4. Any expenditure referred to in Section 40A of Income-tax Act. Section 58(3) lays down that in the case of a foreign company; the provisions of Section 44D will apply while computing income under this head.

Caution No deduction is allowed in respect of any expenditure or allowance in computing the income by way of winnings from lotteries crossword puzzles races (including horse races) card games and other games of any sort or from gambling or betting of any form or nature whatsoever. The prohibition however will not apply in respect of income of an assessee who is owner of horses maintained for running in horse races [Section 58(4)]. The winnings are now taxed at the rate of 30%. The amount is taxable at source and it does not matter whether amount goes to one or more recipients. Similarly the amount spent in buying of in fructuous tickets is not deductible as the gross amount will be taxed.

Self Assessment

State whether the following statements are true or false:

11. Interest on money borrowed for investment in securities can be claimed as a deduction under income from other sources.

12. Where a regular monthly amount is payable by an employer to a person belonging to the family of an employee in the event of his death, i.e., 'family pension', a sum equal to 33 % of the income or 20,000, whichever is less, is allowable as a deduction.

13. In computing the income by way of dividends of a foreign company, no deduction will be allowed under Section 57.

14. 30% deduction is allowed in respect of any expenditure in computing the income by way of winnings from lotteries crossword puzzles races, card games.

13.4 Tax Concessions

Notes

The word "security" has not been defined by the Income-tax Act. Therefore, its natural meaning as well as the meaning, as interpreted in the case laws, has to be adopted. The Shorter Oxford English Dictionary defines "security" as: "a document held by a creditor as guarantee of his right to payment. This implies that unless the payment of debt is secured in some way, a mere "debt" is not a security.

The word "security" denotes a debt or claim, the payment of which is in some way secured. Where the word is used in its normal sense, some form of secured liability is postulated. The word "securities" must be construed in the above defined sense and does not include shares or stock in a company".

Notes The following amounts shall not be deducted in computing income chargeable under the head 'Income from other sources' in the case of any assessee:

1. Any personal expenses of the assessee.
2. Any interest chargeable under the Income-tax Act which is payable outside India and from which income-tax has not been paid or deducted at source.
3. Any payment which is chargeable under the head "Salaries" if it is payable outside India unless tax has been paid thereon or deducted therefrom at source.
4. Any expenditure referred to in Section 40A of Income-tax Act.

Exempted Interest [Section 10(4)]

In the case of a non-resident, any income by way of interest on the securities or bonds notified by the Central Government in the Official Gazette, including income by way of premium on the redemption of such bonds.

Caution No securities or bonds will be specified by the Central Govt. for this purpose on or after 1.6.2002.

In case of an individual any income by way of interest on moneys standing to his credit in a Non-resident (External) Account in any bank in India in accordance with the Foreign Exchange Regulation Act, 1973 and the Rules made thereunder.

Provided that such individual is a person resident outside India as defined in Section 2(q) of the said Act or is a person who has been permitted by the Reserve Bank of India to maintain such account.

Exempted Interest [Section 10(15)]

The interest income from the following securities enumerated specifically at clause 15 of Section 10 of the Income-tax Act is exempted. Hence, the interest thereon shall not be included in the income of the assessee.

1. Income by way of interest, premium on redemption or other payment on such securities, bonds, annuity certificates, savings certificates, other certificates issued by the Central Government and deposits as the Central Government may, by notification in the Official Gazette, specify in this behalf, subject to such conditions and limits as may be specified in the said notification.

Notes

(a) In the case of an individual or a Hindu Undivided family, interest on such Capital Investment Bonds as the Central Government may, by notification in the Official Gazette, specify.

(b) In the case of an individual or a Hindu Undivided family, interest on the notified Relief Bonds.

(c) In the case of :

- a non-resident Indian, being an individual owning the bonds; or
- a nominee or survivor of the non-resident Indian; or
- the donee, being an individual, to whom the bonds have been gifted by the non-resident Indian, the interest received thereon shall be exempt if the bonds are purchased by the non-resident Indian, in foreign exchange and the interest and principal received thereon, whether on maturity or otherwise, is not allowed to be taken out of India. The benefit does not cease even if the non-resident Indian subsequently acquires the status of a resident. But, in the event of premature encashment thereof, the benefit shall cease from the previous year in which the encashment is made.

2. Interest on securities held by the Issue Department of the Central Bank of Ceylon constituted under the Ceylon Monetary Law Act, 1949.

(a) Interest payable to any bank incorporated in a country outside India and authorised to perform central banking functions in that country or any deposits made by it, with the approval of the RBI, with any scheduled bank.

3. Other interests: These include:

(a) Interest payable by Government or a local authority on moneys borrowed by it before June 1, 2001 from or debts owed by it to sources outside India.

(b) Interest payable by an industrial undertaking in India on moneys borrowed by it before June 1, 2001 under a loan agreement entered into with such financial institution in a foreign country as may be approved in this behalf by the Central Government by general or special order.

(c) Interest payable by an industrial undertaking in India on any moneys borrowed or debt incurred by it before June 1, 2001 in a foreign country in respect of purchase outside India of raw materials or components or capital plant and machinery to the extent to which such interest does not exceed the amount of interest calculated at the rate approved by the Central Government in this behalf having regard to terms of the loan or debt and its repayment. Purchase, includes Hire Purchase Agreement or a lease agreement with an option to purchase such plant and machinery.

(d) Interest payable by the Industrial Finance Corporation of India or the IDBI or the Industrial Credit and Investment Corporation of India or Export-Import Bank of India, or the National Housing Bank or the Small Industries Development Bank of India on any moneys borrowed before June 1, 2001 from sources outside India.

(e) Interest payable by any other financial institutions established in India or a banking company on any moneys borrowed before June 1, 2001 from sources outside India under an approved loan agreement.

(f) Interest at the rate approved by the Central Govt. payable by an industrial undertaking in India on any moneys borrowed by it in foreign currency from sources outside India under an approved loan agreement.

(g) Interest payable by a scheduled bank to a non-resident or a person not ordinarily resident on deposits in foreign currency where the acceptance of such deposits by the bank is approved by the Reserve Bank of India.

(h) Interest payable by a public company formed and registered in India, and eligible for deduction under Section 36(1)(viii) with the main objective of carrying on business of providing long term finance for construction or purchase of houses in India for residential purposes on any moneys borrowed by it in foreign currency from sources outside India under an approved loan agreement before the 1st day of June, 2003, to the extent to which such interest does not exceed the amount of interest calculated at the rate approved by the Central Government.

(i) Interest payable by public sector companies on certain specified bonds and debentures subject to such conditions, including the condition that the holder of such bonds or debentures registers his name and the holding with that company, as may be specified by the Central Government by notification in the Official Gazette.

(j) Interest payable by Government on deposits made by an employee of the Central or State Government, or a public sector company out of moneys due to him on account of his retirement, whether on superannuation or otherwise. To be eligible for exemption, the deposit must have been made by the employee in accordance with a scheme notified by the Central Government.

(k) Interest on securities held by the Registrar, Supreme Court, in Reserve Bank's SGL Account No. SL/DHO48.

Self Assessment

Fill in the blanks:

15. ………………………………. is a document held by a creditor as guarantee of his right to payment.

16. The word security denotes a debt or claim, the payment of which is in some way ……………………………….

17. For tax concession purposes securities does not include ………………………. in a company.

18. A mere …………………… is not a security.

19. Any …………………………… chargeable under the Income-tax Act which is payable outside India and from which income-tax has not been paid or deducted at source shall not be deducted in computing income chargeable under the head 'Income from other sources' in the case of any assessee.

13.5 Assessee External to the Range of Tax Liability in Respect of Interest on Securities

Where the securities are held by any of the following persons, interest thereon shall not be included in their income for income-tax purposes:

1. Any authority constituted in India for the purpose of dealing with and satisfying the need for housing accommodation or for the purposes of planning, development or improvement of cities, towns and villages [Section 10(20A)].

2. Approved scientific research association [Section 10(21)].

3. Approved games associations or institutions [Section 10(23)].
4. Any Regimental Fund or Non-public Fund [Section 10(23AA)].
5. An institution existing solely for the development of Khadi or Village industries [Section 10(23B)].
6. Authority established for the development of Khadi and Village Industries [Section 10(23BB)].
7. Anybody or authority constituted for the administration of public religious trusts or endowments [Section 10(23BBA).
8. European Economic Community [Section 10(23BBB)].
9. Others : These include:
    - The Prime Minister's National Relief Fund; or
    - The Prime Minister's Fund (Promotion of Folk Art); or
    - The Prime Minister's Aid to Students Fund; or
    - The National Foundation for Communal Harmony; or
    - Any university or other educational institution existing solely for educational purposes and not for purposes of profits, which is wholly or substantially financed by the government; or
    - Any hospital or other institution for the reception and treatment of persons suffering from illness or mental defectiveness or for the reception and treatment of persons during convalescence or of persons requiring medical attention or rehabilitation, existing solely for philanthropic purposes and not for the purposes of profits and which is wholly or substantially financed by the government; or
    - Any university or other educational institution existing solely for educational purposes and not for purposes of profit if the aggregate annual receipts of such university or educational institution do not exceed the amount of annual receipts as may be prescribed.

Notes **Calculation of "Income from other sources"**

Particulars
Dividend from foreign company
Less: collection charges
Interest on securities
Less: reasonable expenses in connection with the securities
Casual income (winnings from lottery, crow puzzles etc.)
Income from letting P&M, Building etc.
Less: depreciation and other expenses related with it
Family pension
Less: 1/3rd or 15000 whichever is less
Any other income
Less: expenses related with the income
Income from other sources

Contd...

Notes

Grossing up of Income or interest

$$\text{Grossing up of Income or interest} = \text{Net Income/Interest} \times \frac{100}{100 - \text{Rate of Tax}}$$

Rate of TDS for various incomes

Particulars of Payment	Rate of Deduction
Interest Income on bank deposits (if interest exceeds ₹ 10,000 in a year)	10%
Winning from Lottery, crossword, puzzles (TDS applicable if price money exceeds ₹ 5,000)	30%
Winning from horse races (if race winning exceeds ₹ 2500)	30%
Listed debentures (if interest exceeds ₹ 2500)	10%
Unlisted debentures (if interest exceeds ₹ 2500)	10%
Tax free commercial securities	20%

Caselet

Computation of the Income from Other Sources in India

The Computation of the income from other sources of Mr. X as per the details given below for Financial Year 2013–14 will be:

Interest received on debentures	15000
Interest received from taxable bonds	20000
Interest received from Public Provident Fund	30000
Dividend received from mutual funds	10000
Interest received on Saving Bank Account	12000
Accrued Interest on Kisan Vikas Patra	8000
Accrued Interest on National Saving Certificates	5000
Interest received on Income Tax refund	4000
Gift received from a friend	60000
Winning from Television Shows	100000

Solution:

Income from other sources	Amount
Interest received on debentures	15000
Interest received from taxable bonds	20000
Interest received from Public Provident Fund (Exempted) 30000	NIL
Dividend on Mutual Fund (Exempted) 10000	NIL
Interest received on Saving Bank Account	12000
Accrued Interest on Kisan Vikas Patra	8000

Contd...

Accrued Interest on National Saving Certificates	5000
Interest on Income Tax Refund	4000
Gift received from a friend (exempted if amount is 50000/= or less)	60000
Winning from Television shows	100000
Taxable Income from other sources	**224000**

Self Assessment

Interest on securities held by the following institutions, organisations, association or funds are dealt in by which Section of IT Act.

20. Approved scientific research association
21. Approved games associations or institutions
22. Any Regimental Fund or Non-public Fund
23. Authority established for the development of Khadi and Village Industries
24. European Economic Community

Case Study

M. N. Ramaswamy Iyer vs Commissioner of Income-Tax

The assessee is a Hindu undivided family carrying on business of banking and conducting chits. The assessee's accounting year ends on 31st December; and I.T.R. No. 19 of 1967 relates to the assessment year 1958–59, while the other case relates the year 1959–60. For the assessment year 1958–59, the assessee returned a net loss of ₹ 19,302 under business. In arriving at this figure, it made a deduction of ₹ 38,193 by way of interest paid to various parties on loans. This amount included a sum of ₹ 18,525 made up as follows:

1.	Palghat Financing Co. (P.) Ltd.	12,148
2.	Palghat Investment Corporation Ltd.	1,890
3.	Narasimha Bank, Alathur	4,487

For the assessment year 1959–60, the assessee returned a net loss of ₹ 1,890 under business. The deductions made by the assessee in arriving at the above amount consisted of sum ₹ 17,514. The represented interest paid on loans to the following parties:

1.	Palghat Financing Co. (P) Ltd.	10,080
2.	Palghat Investment Corporation Ltd.	1,995
3.	Narasimha Bank	3,090
4.	M. N. Ramaswamy Iyer & Co. Ltd.	2,349

The amount paid as interest by the assessee to the aforesaid concerns in the two years of assessment did not relate to amounts which it borrowed for its banking or chit business, but it represented amounts invested for acquiring shares in the said concerns. The assessee however, claimed to deduct the said amounts under clauses (iii) and (xv) of section 10(2) of

Contd...

Notes

the Act on the ground that the investment in shares was part of its business, and that, at any rate, the acquisition of shares in the said concerns was necessary for the purpose of furtherance of preservation of its own business.

The claim was disallowed by the Income-tax Officer on the ground that these investments did not relate to his business, and that they did not yield any income. It filed appeals before the Appellate Assistant Commissioner, and urged the above claims not only under section 10(2) of the Act, but also under section 12. The Appellate Assistant Commissioner rejected the assessee's claim under section 10(2) on the same ground as was stated by the Income-tax Officer. It also held that the claim was not admissible under section 12 of the Act, as the investments in shares were not a regular investment. The assessee filed appeals before the Income-tax Appellate Tribunal. The appeals were dismissed by a common order dated 26th February, 1964; and these references arose out of the said order. The questions referred in I.T.R. No. 19 of 1967 are:

1. Whether, on the facts and circumstances of the case, the assessee is not entitled to the deduction of the sum of ₹ 18, 525 in computation of his business income for the assessment year 1958–59 under section 10(2)(iii) or (xv) or under section 12 of the Indian Income-tax Act, 1922?

2. Whether, on the facts and circumstances of the case, the disallowance of the interest of ₹ 18,525 as not admissible under section 10(2) (iii) or (xv) or under section 12 of the Indian Income-tax Act, 1922, is valid in law?"

The questions referred in I.T.R. No. 20 are exactly the same, except that ₹ 17,514 has to be substituted for ₹ 18,525. In substance, questions Nos. 1 and 2 are the same; and they can admit of only the same answer. Both the questions consist of two parts: and we shall first deal with the first part.

The question whether the acquisition of shares by the assessee in the concerns referred to above was for the purpose of furtherance or preservation of its own business is one of fact. The Appellate Tribunal, after a detailed consideration of the facts and circumstances of the case, held that the said investments were unconnected with the assessee's business. In the light of this finding, the learned counsel for the assessee did not rightly press the assessee's claim for deduction on this ground. The assessee is not admittedly a dealer in shares; and purchase of shares is not obviously a part of its business. If any income arose to the assessee out of the investments on shares, it would not fall under the head "business", but only under the head "other sources". So the expenditure incurred by way of interest paid in respect of investments made for buying shares cannot be claimed as a business expenditure of the assessee. It must, therefore, follow that the first part of the questions referred to us in both these cases must be answered against the assessee.

The next question for consideration is whether the claim can be allowed under section 12 of the Act. The reason for disallowing this claim is stated by the Appellate Tribunal in paragraph 25 of its order; and it reads as follows:

"In our opinion, section 12 has also no application. The case relied on by the assessee's learned counsel, Appa Rao v. Commissioner of Income-tax, preceded on the finding that the expenditure by way of payment of interest was incurred solely for the purpose of making or earning such income from the shares acquired with the amount borrowed. The only point made out by the department was that there was no income. The facts in the assessee's case are entirely different. The Appellate Assistant Commissioner stated that the shares had come out of borrowals but that was on an overall position of the capital account and profits and the amount of investments from year to year. There is no direct connection between the money borrowed and the purchase of shares. Even according to

Contd...

the assessee there is no correlation between the purchase of shares and the amounts standing to the credit of the accounts of Palghat Financing Company (Private) Ltd., etc."

We are not quite able to follow what the Appellate Tribunal has meant by saying that "there is no direct connection between the money borrowed and the purchase of shares", and that "there is no correlation between purchase of shares and the amounts standing to the credit of the accounts of Palghat Financing Company (Private) Ltd., etc." In paragraph 10 of the statement of the case in I.T.R. No. 19 of 1967, the Appellate Tribunal said.

"The Income-tax Officer disallowed the above sums for the reasons that the above were sister concerns of the assessee, that the amounts on which interest had been paid had been used in the purchase of shares, and that these amounts had not been used for the purpose of the business."

The Appellate Assistant Commissioner has dealt with the character of the investment; and it concluded as follows:

"From the history of the investment given above it will be seen that the share is not a business transaction nor is it a regular investment. It follows that the interest payment attributable to the borrowal utilised in the investment is not a permissible deduction either under section 10(2)(iii) or under section 10(2)(xv)."

Dealing with the assessee's contention that the two amounts concerned in these cases would fall under clause (iii) or (xv) of section 10(2) of the Act, the Appellate Tribunal stated as follows in its order in the assessee's appeals:

"Now it is no doubt true that purchase of shares is a normal activity for a person carrying on banking business. But in the circumstances of the case, we are not satisfied that the purchase of shares in the Palghat Financing Company (Private) Ltd., Palghat Investment Corporation Ltd., M. N. Ramaswamy Iyer & Co. Ltd., were in the course of the normal banking business. Even according to the assessee the purchase of the shares was to prevent some scare. We may mention here that beyond making this claim, no material was placed before us to show that there was a real threat to any of the businesses.

The pattern of investment shows the preference to shares in which the assessee's family was interested. Except a sole purchase of a share in Nedungadi Bank Ltd., the assessee had not made any investment in any other industrial shares, or shares in other companies. Normally a banker invests in shares with a view to supplant his income but in this case it cannot be said that the purchase of these shares had been made with any such purpose. In our opinion the investment of ₹ 6,69,243 in the year ending December 31, 1957, and ₹ 6,81,633 in the year ending December 31, 1958, was not for the purpose of business and, therefore, the interest paid on moneys corresponding to that amount cannot be allowed as a deduction".

It is, therefore, not in dispute that the sums of ₹ 18,525 and ₹ 17,514 which the assessee claimed for the assessment years 1958–59 and 1959–60 respectively represented the interest attributable to the amounts invested on shares. This is the basis on which the claim of the assessee in respect of the said amounts has been dealt with by the Appellate Tribunal, and the subordinate authorities.

It is not disputed that, if the assessee earned any dividend on the shares held by the assessee, it would be income under the head "other sources". Admittedly, during the two previous years concerned in these cases, the assessee did not receive any dividend; but it had incurred expenditure by way of interest paid on amounts borrowed for acquiring shares. The question for determination is whether the said expenditure is allowable under

Contd...

section 12(2) of the Act in computing the income of the assessee under "other sources". We shall now quote the relevant parts of section 12:

12. Other sources.

1. The tax shall be payable by an assessee under the head income from other sources in respect of income, profits and gains of every kind which may be included in his total income (if not included under any of the preceding heads).

   Income from other sources shall include dividends.

2. Such income, profits and gains shall be computed after making allowance for any expenditure (not being in the nature of capital expenditure) incurred solely for the purpose of making or earning such income, profits or gains, and further in the case of any income by way of dividend, for any reasonable sum paid by way of commission or remuneration to a banker or any other person realising such dividend on behalf of the assessee, provided that no allowance shall be made on account of:

   (a) any personal expenses of the assessee, or

   (b) any interest chargeable under this Act which is payable without the taxable territories, not being interest on a loan issued for public subscription before the 1st day of April, 1938, or not being interest on which tax has been paid or from which tax has been deducted under section 18, or

   (c) any payment which is chargeable under the head salaries, if it is payable without the taxable territories and tax has not been paid thereon nor deducted therefrom under section 18."

The learned counsel for the assessee relied on a decision of the Madras High Court in P. V. Mohamed Ghouse v. Commissioner of Income-tax. In that case, the owner of a transport business borrowed money for purchasing shares in another transport company and claimed the interest, which he had paid on the money borrowed, as a deduction against his income from transport business under section 10(2)(iii) of the Act, and alternatively under section 12(2). The contention that it would fall under section 10(2)(iii) was rejected by the High Court; but it allowed the claim under section 12(2). Upholding the claim, their Lordships said:

"It cannot be doubted that if the assessee had earned income by way of dividend from these shares, the interest payment of ₹ 7,500 would be a proper charge on that income. So much is conceded by Mr. Ranganathan, learned counsel for the department. But then, it is pointed out that the assessee did not earn any dividend income from these shares in the relevant year, and, in fact, he had no income to be assessed under the miscellaneous head of section 12. The submission on behalf of the revenue is that the absence of any income by way of dividend or other miscellaneous income under section 12 operates as a bar against the assessee to claim the interest payment as a revenue charge.

It is now a well-accepted rule of income-tax law that what the statute allows as a proper allowance or expenditure, and which can be brought on the debit side of the assessee profit and loss account to off-set his credit receipts and to compute the income, profits and gains chargeable, cannot be defeated by the mere accident of the assessee not being in a position to show that the receipts exceed the expenses or that the credit side is larger in amount than the debit side."

This decision fully supports the claim of the assessee.

The learned counsel for the revenue advanced before us the same contention as was put forward by his counterpart before the Madras High Court in the above case, and submitted

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that the above decision did not lay down the correct law. He relied on the decision of the Calcutta High Court in Madanlal Sohanlal v. Commissioner of Income-tax in support of his contention. In that case, P. B. Mukharji J. said:

"Whether a return of income under section 12 ultimately is reduced to nil or a loss is immaterial so long as there is some gross income or return, but where there is only an expenditure and no income whatever and no return whatever, than, I do not think it will be proper to apply the principle of deduction recognised in section 12(2) of the Act."

Bose J. took the same view by a concurring judgment. The question has been considered at some length by the learned judges in the above case; and it would be seen that they followed the decision of the Patna High Court in Maharajadhiraj Sir Kameshwar Singh v. Commissioner of Income-tax as against the view taken by the Bombay High Court in Ormerods (India) Private Ltd. v. Commissioner of Income-tax and the High Court of Allahabad in Chhail Behari Lal v. Commissioner of Income-tax. All these three decisions were considered by the Madras High Court in K. Appa Rao v. Commissioner of Income-tax; and that court adopted the view of the Bombay High Court, which dissented from the view of the Patna High Court. Now all these decisions including the Calcutta case relied on by the learned counsel for the revenue have been reviewed in the decision of the Madras High Court in P. V. Mohamed Ghouse v. Commissioner of Income-tax. All that could be said for and against the contention that an expenditure incurred solely for the purpose of making or earning an income under "other sources" is an allowable deduction under section 12(2) of the Act, even if there is no income under that head during the previous year, has been said and considered in the aforesaid decisions; and it is, therefore, unnecessary for us to re-state them. With respect, we may say that the view taken by the High Courts of Bombay, Allahabad and Madras appeals to us as the correct one.

Lord Thankerton, in his speech in the decision of the House of Lords in Hughes v. Bank of New Zealand, said:

"Expenditure in the course of the trade which is unremunerated is none the less a proper deduction, if wholly and exclusively made for the purposes of the trade. It does not require the presence of a receipt on the credit side to justify the deduction of an expense."

In Eastern Investments Ltd. v. Commissioner of Income-tax, the Supreme Court was dealing with a claim under section 12(2) of the Act for deduction of interest paid by the assessee on debentures; and it said:

"It is not necessary to show that the expenditure was a profitable one or that in fact any profit was earned."

According to the decision of the Patna and the Calcutta High Courts, the question of allowance of the expenditure under section 12(2) of the Act does not arise, unless there is some income actually received under the head "other sources". It is this view that was pressed before us by the learned counsel for the revenue. He did not say that the position would be the same in respect of income under other heads. But he submitted that it was so in the case of income under "other sources"; and he relied on the following statement of P. B. Mukharji J. in Madanlal Sohanlal v. Commissioner of Income-tax:

"The principles for deduction of expenditure are different in different sections under different heads of income. It is a wrong attempt to find or seek any universal principle of deduction for allowance for expenditure."

With respect, we agree with the above observation; but it does not lead to the conclusion that a claim under section 12(2) of the Act for deduction of expenditure would lie only

Contd...

when there is a receipt of income. If that were so, an assessee, who does not receive any income under the head "other sources", and incurs an expenditure of ₹ 10,000, would not be entitled to set off this amount, which happens to be a loss under that head, against his income under other heads as provided by section 24 of the Act whereas, if his income is ₹ 10 as against the same expenditure of ₹ 10,000, he would be entitled to set off the loss of ₹ 9,990 against his income under other heads. The learned counsel for the revenue submitted that what is stated above would be the correct position on a true construction of section 12 of the Act. This is a totally unreasonable and almost an assured position. The language employed in section 12 of the Act does not compel us to construe it in that manner. Viewed in the light of the right given to an assessee under section 24 of the Act to set off loss under one head against his income or profits under other heads, and the scheme adopted in the Act for computing the total income of an assessee, which is charged to tax, we feel no hesitation in holding that an assessee's right for allowances under section 12(2) of the Act does not depend on the fact whether, in the particular year concerned, he received any income under the head "other sources". We, therefore, hold that the amounts paid by the assessee by way of interest on account of investments on shares are allowances admissible under section 12(2) of the Act.

In the result, we answer the first part of the first question referred to this court in both the cases in the negative, and against the assessee. We answer the second part of the said question in the affirmative, and in favour of the assessee. The above answer would give the second question in both the cases. In the circumstances of this case, the parties will bear their own costs. A copy of this judgment will be sent to the Income-tax Appellate Tribunal as required by section 66(5) of the Act.

Questions

1. Study and analyze the case.
2. Write down the case facts.
3. What do you infer from it?

Source: http://www.indiankanoon.org/doc/31561/

13.6 Summary

- Income chargeable under Income-tax Act, which does not specifically fall for assessment under any of the heads discussed earlier, must be charged to tax as "income from other sources".
- Section 56(2) specifically provides for the certain items of incomes as being chargeable to tax under the head such as Dividend, Keyman Insurance policy, Winnings from lotteries, Contribution to Provident fund, Income by way of interest on securities, Income from hiring machinery etc., Hiring out of building with machinery, Money Gifts, Share premiums in excess of the fair market value to be treated as income, income by way of interest received on compensation.
- The entire income of winnings, without any expenditure or allowance or deductions under Sections 80C to 80U, will be taxable. However, expenses relating to the activity of owning and maintaining race horses are allowable. Further, such income is taxable at a special rate of income-tax i.e., 30% + surcharge + cess @ 3%.
- Admissible Deductions: The income chargeable under the head "Income from other sources" is the income after making the deductions such as (a) sum paid by way of commission or remuneration to a banker or any other person for the purpose of realising such interest, (b) the deduction shall be allowable in accordance with the provisions of Section 36(1)(va),

i.e., if the employer has credited the employee's accounts in the respective funds, (c) a sum equal to 33-1/3% of the income or ₹ 15,000, whichever is less, is allowable as a deduction from family pension; d) a deduction of a sum equal to 50% of from Interest on compensation or enhanced compensation, and e)any other expenditure (not being in the nature of capital expenditure) laid out or expended wholly and exclusively for the purpose of making or earning such income.

- Inadmissible deductions: The following amounts shall not be deducted in computing income chargeable under the head 'Income from other sources' like (a) Any personal expenses of the assessee, (b) Any interest chargeable under the Income-tax Act which is payable outside India and from which, (c) income-tax has not been paid or deducted at source, (d) Any payment which is chargeable under the head "Salaries" if it is payable outside India unless tax has been paid thereon or deducted therefrom at source and Any expenditure referred to in Section 40A of Income-tax Act.
- The basis of charge on income by way of interest on securities is on "receipt" basis if books of account are maintained on cash basis. If the assessee does not maintain books of account or, when he maintains books of account on the basis of "mercantile system", it is taxable on "due" basis.

13.7 Keywords

Debt: An amount of money borrowed by one party from another.

Dividend: It is a payment made by a corporation to its shareholders, usually as a distribution of profits.

Fair Market Value: It is an estimate of the market value of a property, based on what a knowledgeable, willing, and unpressred buyer would probably pay to a knowledgeable, willing, and unpressured seller in the market.

Gambling: It is the wagering of money or something of material value (referred to as "the stakes") on an event with an uncertain outcome with the primary intent of winning additional money and/or material goods.

Interest: It is a fee paid by a borrower of assets to the owner as a form of compensation for the use of the assets.

Provident Fund: It is a term for pension fund.

Receipt: A receipt is a written acknowledgment that a specified article or sum of money has been received.

Securities: It is a tradable asset of any kind.

13.8 Review Questions

1. What constitutes income from other sources?
2. Discuss in detail the deductions which are available to an assessee under the head 'income from other sources'.
3. Define dividends.
4. Converse the cases in which payment by way of loan or advance to the amount of accumulated profits by a closely held company is treated as dividend.
5. Prepare a list of incomes chargeable under the head "Income from other sources".

6. Explain in brief the deductions are allowed under the head "Income from other sources".
7. Write a short note on expenses are not allowed to be deducted under the head "Income from other sources".
8. Anubhav has the following investments in the previous year ended 31st March, 2013:
   (a) 7,160 received as interest on securities of Karnataka government.
   (b) 9,000 received as interest on securities of a listed paper manufacturing company.
   (c) 7,200 received as interest on the unlisted securities of a sugar company.
   (d) 30,000, 11% securities (unlisted) of a textile company.
   (e) 20,000, 10% Tamil Nadu government loan.
   (f) 50,000, 13.5% listed debentures of Dolly Ltd.

   Interest on all securities is payable on 30th June, and 31st December. The bank charges 1.5% commission on net realisation of interest as collection charges. Danny also received ₹ 15,000 as director's fee from a company. His other incomes are – winnings from horse race: 25,000 (gross); and interest on post office savings bank account: 6,000.

   Find out taxable income of Anubhav from other sources for the assessment year 2013–14.
9. Sanjeev a Member of Parliament (MP) from Uttar Pradesh submits the particulars of his income for the assessment year 2013–14. Compute his income from other sources:
   (a) Salary as MP 4,60,000
   (b) Daily allowances as MP 1,80,000
   (c) Dividend received from a domestic company 60,000
   (d) Winnings from horse race (Gross) 40,000
   (e) Winnings from Sikkim State lotteries received (Net) 70,000
   (f) Agricultural income in Sri Lanka 4,00,000

   He received a royalty of 1,00,000 from a book of stories written by him. He claimed 12,000 as expenditure on stationery and typing. He lets out one of his buildings along with plant, machinery and furniture for 50,000 per month. He claimed the following expenses as deduction for this building – Insurance: ₹ 10,000; repairs: 15,000; depreciation: 40,000. Interest credited to his recurring deposit account and cumulative time deposit account in post office was 32,000 and 48,000 respectively.

Answers: Self Assessment

1. Section 56(2)
2. Keymans Insurance Policy
3. Taxable
4. Profits and gains from business and profession
5. 50,000
6. True
7. False
8. True
9. True
10. True
11. True
12. False
13. True
14. False

Notes

15. Security
16. Secured
17. Shares or stocks
18. Debt
19. Interest
20. Section 10(21)
21. Section 10(23)
22. Section 10(23AA)
23. Section 10(23BB)
24. Section 10(23 BBB)

13.9 Further Readings

Books

Aggarwal, K. *Direct Tax Planning and Management.* Atlantic Publications.

Ahuja, G. K. & Gupta, Ravi. *Systematic Approach to Income Tax.* Bharat Law House.

Lakhotia, R. N. *Income Tax Planning Handbook.* Vision Books.

Singhania, V. K. & Singhania, Kapil. *Direct Taxes Law & Practice.* Taxmann Publications.

Srinivas E. A. *Handbook of Corporate Tax Planning.* Tata McGraw Hill.

Online links

http://finance.indiamart.com/taxation/income_tax/tax_income_other_sources.html

http://law.incometaxindia.gov.in/dittaxmann/incometaxacts/2005itact/casesec56.htm

http://www.caclubindia.com/articles/understanding-income-from-other-source-with-latest-case-laws-14201.asp

http://www.mbaknol.com/tax-management/income-from-other-sources/

http://www.scribd.com/doc/24201390/Income-Form-Other-Sources-9

http://www.slideshare.net/navinmkhubchandani/dit-project

http://www.wirc-icai.org/material/Income%20From%20other%20sources-AY0910.pdf

Unit 14: Advance Tax Planning and Tax Relief

CONTENTS

Objectives

After studying this unit, you will be able to:

- Discuss the Concept of Advance Tax Payment
- Describe Due Dates and Interest on Late Payment on Advance Tax Payment
- Explain Double Taxation Relief
- Elucidate Double Taxation Relief Provisions in India

Introduction

Tax payers whose total income is likely to be chargeable to tax for the assessment year are required to pay tax in advance during the financial year (April 1 to March 31) on their estimated current income, which will be assessable to tax during the next following financial year called assessment year. The current income for this purpose means the total income which will be chargeable to tax in the relevant assessment year. The advance tax payable is the tax on the current income minus the tax deductible at source or collectible out of any income included in the current income. Although the income of previous year of the assessee is taxable in the immediately following assessment year, the assessee has to pay advance tax during the Financial Year proceeding the assessment year on the basis of his own computation of income. At present all items of income including capital gains, winnings from lotteries, etc. are liable for payment of advance tax. So, before one can embark on a study of advance tax planning and tax relief, it is absolutely vital to understand the concept of Advance Tax Payment along with its Due Dates and Interest on Late Payment on it as well as understand the meaning of Double Taxation Relief and its provisions in India. The purpose of this Unit is to enable the students to comprehend basic expressions. Therefore, all such basic terms are explained and suitable illustrations are provided to define their meaning and scope.

14.1 Concept of Advance Tax Payment

Advance Payment of tax is another method of collection of tax by the Central Government in the Form of 'Prepaid Taxes'. Such advance tax is in addition to deduction of tax at source or collection of tax at source. Scheme of advance payment of tax is also known as 'pay as you earn' scheme i.e., the assessee is required to pay tax during the course of earning of income in the previous year itself, though such income in chargeable to tax during the assessment year. Advance tax is payable on current income in instalments during the previous year.

Example: All persons including salaried employees and pensioners, in whose case tax payable during a Financial Year is ₹ 10,000 or more after adjusting all deductions, rebates & TDS are required to pay Advance Tax.

The provisions of advance tax are applicable on all types of persons irrespective of the residential status of the person. The advance tax is paid in the previous year itself. Thus, the tax is paid in the year of earning of income, in other words the earning of income and payment of tax goes simultaneously. Thus, the tax is paid as income is earned. This scheme of advance payment of tax is also called pay as you earn scheme, i.e., pay tax as you earn income. Payment of Advance Tax on estimated Income during the current year is required to pay for all assesses.

Example: In the Financial Year 2010–11 (Assessment Year 2011–12) advance tax is payable in instalments during the period 01.04.2010 to 31.03.2011 itself. The total amount of Advance Tax will be adjusted during the Assessment Year 2011–12 at the time of assessment.

Tax on current income at the rate in force during the financial year will be calculated by the Assessing Officer. From such tax calculated, the amount of income-tax which would be deductible or collectible at source during the said financial year shall be reduced and the amount of income-tax as so reduced shall be the advance tax payable. In Revision of order for payment of Advance Tax [Section 210(4)], if, after making the above order, by the Assessing Officer, but before 1st March, return of income is furnished by the assessee or a regular assessment of the assessee is made in respect of any later year, for any higher figure the Assessing officer may make an amended/revised order to pay advance tax. On receipt of the revised order, the assessee will have to pay advance tax accordingly.

Notes **Payment of Advance Tax in Case of Capital Gains/Casual Income [Proviso to Section 234C]**

(1) Advance tax is payable by an assessee on his/its total income, which includes capital gains and casual income like income from lotteries, crossword puzzles etc.

(2) Since it is not possible for the assessee to estimate his capital gains, income from lotteries, etc., it has been provided that if any such income arises after the due date for any instalment, then, the entire amount of tax payable (after considering tax deducted at source) on such capital gains or casual income should be paid in the remaining instalments of advance tax which are due.

(3) Where no such instalment is due, the entire tax should be paid by 31st March of the relevant financial year.

(4) No interest liability under section 234C would arise if the entire tax liability is so paid.

14.1.1 Who is Liable to Pay Advance Tax?

If the Income Tax Liability of any assessee is more than ₹ 10,000 in a financial year, then he is liable to pay such tax in instalments during the year itself rather than paying this tax at the end of the year. This tax which is payable during the year is called "Advance Tax" or "pay as you earn tax" as tax is liable to be paid at the time the income is earned i.e. during the year rather than paying this tax at the end of the year.

(1) Advance Tax is required to pay under section 208 of Income Tax Act 1961 for all those assesses including Salaried and Pensioners whose advance tax on estimated income comes (after deducted TDS/TCS if any) to ₹ 10,000/- or more in a Financial Year F.Y. 2010–11.

Thus, if Income Tax payable (after deducting all deductions, rebates and TDS) is less than 10000 in a financial year 2010–11, there is no need to deposit any Advance Tax and the same tax will be deposited at the time of self assessment before filing of income tax return.

(2) In case an order u/s 210(3) is received by the person to pay an amount by way of Advance Tax in Form No. 28, should deposit such amount in the instalments as specified in the order. This type of orders can be issued upto the last day of February of the financial year.

If that person estimates his income at a higher amount than that specified in the orders u/s 210(3), then he should pay advance tax in accordance with such higher estimate.

However under sections 210(4) & (5) of Income Tax Act 1961, if he estimates him income at a lower amount, then he should send an estimate of such lower income in Form28-A, before the next instalment falls due and deposit the remaining instalments of advance tax accordingly.

Notes **Important Note for Salaried Tax-Payers**

Advance Tax is different from Tax Deducted at Source (TDS). In case of salaried people, normally tax is deducted at source from their salaries, by the employer. Their income for the year is estimated, tax calculated thereon and 1/12th of such estimated tax is deducted from their monthly salary bill.

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Notes

Salaried persons are normally not required to pay advance tax. However, in case the tax liability estimated for the year is more than the TDS, then such employees shall be liable to pay advance tax as indicated above.

14.1.2 Computation and Payment of Advance Tax where the Calculation is Made by the Assessee Himself [Section 209]

As per the various provisions [Section 208 to 219] relating to Advance tax, tax shall be payable in advance during the financial year in respect of the total income of the assessee which would be chargeable to tax during the assessment year immediately following the financial year. Such income shall be referred to as 'Current income'. We know that income earned during the financial year 2010–11 shall be charged to tax in the assessment year 2011–12. but the assessee in required to pay tax, in advance, on the taxable income of financial year 2010–11 during the financial year 2010–11 itself, if certain conditions are fulfilled. Thus, Advance tax payable by an assessee in the financial year on his own accord shall be computed as follows:

Step 1: Estimation of Income: Current income of the financial year for which the advance tax is payable should be estimated.

Step 2: Computation of Tax: The tax payable on estimated income at the rates applicable for the financial year should be computed.

Step 3: Adjustment of Rebate: From the tax computed in Step 2, rebate if any likely to be allowed under Section 88E should be reduced.

Step 4: Surcharge on Tax: On the net tax computed in step 3, Surcharge as applicable should be added and relief, if any, under section 89 should be allowed.

Step 5: Education cess @ 2% of tax and Surcharge is to be added.

Step 6: Deduction of Tax at Source: Tax deductible at source as per relevant provisions should be deducted from the tax payable before payment of net amount of tax.

Step 7: Advance Tax Payable: The balance amount is the advance tax payable and if it happens to be more than ' 5,000, it will be payable in certain instalments as provided in Section 211.

14.1.3 How to Deposit Advance Tax

Advance Tax can be deposited through Challan No. 280 in the Government Treasury (RBI) or any of the authorised branches of nationalised banks. Printed challan forms are available with the Income Tax Office free of cost. While filing challan the following fields are required to be filed.

- Assessee's Name
- Complete Address of Assessee.
- Permanent Account Number
- Assessment Year
- Assessing Officer's Ward or Circle
- Amount of Advance Tax, Surcharge and Cess (if any).

Online deposit of Advance Tax is best payment method. When we deposit or pay online Advance Tax, there is no need to collect Physical Challan No. 280 or no need to stand in big rows to deposit advance tax in banks or treasury etc. Thus, the payment of Advance Income Tax is to be made through Challan No. 280 by selecting Advance Tax (100) as the type of payment as shown Figure 14.1.

Notes

Figure 14.1: Challan No. 280

* Important : Please see notes overleaf before filling up the challan

Single Copy (to be sent to the ZAO)

CHALLAN NO./ ITNS 280	**Tax Applicable** (Tick One)* **(0020) INCOME-TAX ON COMPANIES (CORPORATION TAX)** ☐ **(0021) INCOME TAX (OTHER THAN COMPANIES)** ☐	Assessment Year ☐☐☐☐ - ☐☐

Permanent Account Number

Full Name

Complete Address with City & State

Tel. No. Pin

Type of Payment (Tick One)

Advance Tax (100) ☐	**Surtax (102)** ☐
Self Assessment Tax (300) ☐	**Tax on Distributed Profits of Domestic Companies (106)** ☐
Tax on Regular Assessment (400) ☐	**Tax on Distributed Income to Unit Holders (107)** ☐

DETAILS OF PAYMENTS	Amount (in Rs. Only)	FOR USE IN RECEIVING BANK
Income Tax		Debit to A/c / Cheque credited on
Surcharge		☐☐ - ☐☐ - ☐☐
Education Cess		D D M M Y Y
Interest		
Penalty		
Others		SPACE FOR BANK SEAL
Total		
Total (in words)		

CRORES	LACS	THOUSANDS	HUNDREDS	TENS	UNITS

Paid in Cash/Debit to A/c /Cheque No. Dated

Drawn on

(Name of the Bank and Branch)

Date: Rs.

Signature of person making payment

Taxpayers Counterfoil (To be filled up by tax payer) SPACE FOR BANK SEAL

PAN

Received from

(Name)

Cash/ Debit to A/c /Cheque No. For Rs.

Rs. (in words)

Drawn on

(Name of the Bank and Branch)

on account of Companies/Other than Companies/Tax

Income Tax on (Strike out whichever is not applicable)

Type of Payment (To be filled up by person making the payment)

for the Assessment Year ☐☐☐☐ - ☐☐ Rs.

Source: http://law.incometaxindia.gov.in/dittaxmann/incometaxrules/pdf/challanitns-280.pdf

Caution

1. Please use a separate challan for each type of payment.
2. Please note that quoting your Permanent Account Number (PAN) is mandatory.
3. Please note that quoting false PAN may attract a penalty of ₹ 10,000/- as per section 272B of I.T. Act, 1961.
4. Please note that to deposit Appeal Fees either Major Head 020 or 021 (depending upon the tax payer's status) has to be stocked under 'Tax Applicable'. Followed by this; Minor Head: Self Assessment Tax (300) has to be ticked under 'Type of Payment' and the amount is to be filled under others in 'Details of Payments'.
5. To deposit taxes, appeal fees, etc. in respect of block period cases; enter the first Assessment Year of the block period followed by the last Assessment Year of the period. For example, if the block period is 1/04/85 to 5/3/96, it would be entered as 1986–97 in the space indicated for Assessment Year. If taxes are being deposited, tick the box Self Assessment (300) under Type of Payment and fill up amount under 'Tax' while in respect of appeal fees, enter amount under 'Others'.

Please use this challan for depositing taxes (types of payment) mentioned overleaf.

Kindly do not use this challan for depositing tax deduction at source (TDS)

Kindly ensure that the bank's acknowledgement contains the following:

1. 7 DIGIT BSR CODE OF THE BANK BRANCH
2. DATE OF DEPOSIT OF CHALLAN (DD MM YY)
3. CHALLAN SERIAL NUMBER

These will have to be quoted in your return of income.

Self Assessment

State whether the following statements are true or false:

1. Advance Payment of tax is method of collection of tax by the Central Government in the Form of Prepaid Taxes.
2. The advance tax is not paid in the previous year.
3. Tax on current income at the rate in force during the financial year will be calculated by the Assessing Officer.
4. Advance Tax cannot be deposited through Challan.

14.2 Advance Tax Payment: Due Dates and Interest on Late Payment

Advance Tax receipts help the Govt. to receive a constant flow of tax receipts throughout the year so that expenses can be incurred rather than receiving all tax payments at the end of the year. Advance Tax is liable to be paid by all assesses like Salaried, Self Employed, Businessman etc. before the filing of Income Tax Return.

For Individuals with Salary as the sole source of income, Advance Tax would be taken care of by the TDS deducted by the employer at the time of payment of salaries as reflected in Form 16 and thus there would hardly be any Advance Tax payable. For all assesses earning income from any source other than salary, Advance Tax is payable in instalments. Advance tax on the current income calculated in the manner laid down in section 209 shall be payable by:

(i) all the companies, who are liable to pay the same, in four instalments during each financial year and the due date of each instalment and the amount of such instalment shall be as specified in Table 14.1 below:

Table 14.1: Due Date and Amount Payable under Advance Tax

Due date of instalment	Amount payable
On or before the 15th June	Not less than fifteen per cent of such advance tax.
On or before the 15th September	Not less than forty-five per cent of such advance tax, as reduced by the amount, if any, paid in the earlier instalment.
On or before the 15th December	Not less than seventy-five per cent of such advance tax, as reduced by the amount or amounts, if any, paid in the earlier instalment or instalments.
On or before the 15th March	The whole amount of such advance tax as reduced by the amount or amounts, if any, paid in the earlier instalment or instalments.

S*ource:* http://law.incometaxindia.gov.in/DitTaxmann/IncomeTaxActs/2005ITAct/section211.htm

(ii) all the assesses (other than companies), who are liable to pay the same, in three instalments during each financial year and the due date of each instalment and the amount of such instalment shall be as specified in Table 14.2:

Table 14.2: Due Date and Amount Payable by All Assessees (Except Companies)

Due date of instalment	Amount payable
On or before the 15th September	Not less than thirty per cent of such advance tax.
On or before the 15th December	Not less than sixty per cent of such advance tax, as reduced by the amount, if any, paid in the earlier instalment.
On or before the 15th March	The whole amount of such advance tax as reduced by the amount or amounts, if any, paid in the earlier instalment or instalments.

Source: http://law.incometaxindia.gov.in/DitTaxmann/IncomeTaxActs/2005ITAct/section211.htm

Provided that any amount paid by way of advance tax on or before the 31st day of March shall also be treated as advance tax paid during the financial year ending on that day for all the purposes of this Act.

Did u know? If the notice of demand issued under section 156 in pursuance of an order of the Assessing Officer under sub-section (3) or sub-section (4) of section 210 is served after any of the due dates specified in sub-section (1), the appropriate part or, as the case may be, the whole of the amount of the advance tax specified in such notice shall be payable on or before each of such of those dates as fall after the date of service of the notice of demand.

Task State whether Mr. X is liable to pay advance tax and if yes then what amount should be paid by what date. The income of Mr. X is ₹ 2,00,000.

14.2.1 Interest under Section 234C for Deferment of Payment of Tax

If you don't pay an advance tax instalment in full, you have to pay interest at 1 per cent a month for three months on the amount that falls short of the required payment. However, in the case of default on the last instalment (March 15), the penal interest of 1 per cent is chargeable for only a month is shown in Table 14.3:

Table 14.3: Interest under section 234C is liable to be paid @ 1% per month

(a)	Advance Tax paid on or before 15th Sept	$<$	30% of the Tax Due on Returned Income
		OR	
(b)	Advance Tax paid on or before 15th Dec	$<$	60% of the Tax Due on Returned Income
		OR	
(c)	Advance Tax paid on or before 15th Mar	$<$	Tax Due on Returned Income
		OR	
(d)	No Tax has been paid by the Assessee		

Source: http://www.rupeex.com/doc/advancetax.html

Example: Let's say you are an individual taxpayer and are liable to pay ₹ 10,000 by way of advance tax. Suppose you pay ₹ 9,500 in three instalments (₹ 3,000 on September 14, ₹ 2,000 on December 15, and ₹ 4,500 on March 15), would you have kept to your payment schedule?

There will have been no default in respect of the first instalment (₹ 3,000, which is 30 per cent of ₹ 10,000). The second instalment amount should, however, have been ₹ 3,000 (60 per cent of ₹ 10,000, less ₹ 3,000 paid in the first instalment). Hence, the shortfall is ₹ 1,000, on which the interest payable is ₹ 30 (1 per cent of ₹ 1,000 for three months). Since the third instalment is ₹ 4,500, there will have been a shortfall of ₹ 500, on which the interest charged would be ₹ 5 (1 per cent of ₹ 500 for a month). Thus, you end up with a penal interest of ₹ 35 for the year. If in the last month, that is March, you delay payment of the last instalment by even a day, you will have to pay interest on the entire balance of ₹ 5,000.

This has reference to Section 234C of Income Tax Act.

14.2.2 Consequences of Non-payment of Advance Tax

If the amount of advance tax paid is less you will have to pay penalty interest as per the below:

For Non-Corporate assessee:

1. If advance tax paid in the first two instalments is less than specified, simple interest @ 1% per month is charged on the deficit amount for a period of 3 months.
2. If the aggregate of advance tax paid is less than 90% of tax payable on 15th March penalty of simple interest @ 1% per month is charged on the amount shortfall until the tax is paid

For Corporate assessee:

Simple interest @ of 1% is charged on the deficit amount for a term of 3 months if you have failed to pay advance tax or if advance tax paid is less than tax due as per the above slab. For the 4th and final instalment if the advance tax paid is less than 90% of tax payable simple interest @ 1% per month is charged on the deficit from 1st April until the tax is fully paid.

Self Assessment

Fill in the blanks:

5. Advance Tax is liable to be paid by all assessees like Salaried, Self Employed, Businessman etc. before the filing of…………………….
6. If advance tax paid in the first two instalments is less than specified, simple interest @ 1% per month is charged on the deficit amount for a period of ……………months.
7. For …………………with Salary as the sole source of income, Advance Tax would be taken care of by the TDS deducted by the employer at the time of payment of salaries.
8. For all ………………earning income from any source other than salary, Advance Tax is payable in instalments.

Caselet

Citi's Deferred Tax – An Asset of Dubious Worth

Citigroup is at the centre of a dispute among analysts and accounting experts over whether it should set aside funds to cover $50bn of deferred taxes, a move that would reduce its capital buffer and weaken its balance sheet. As it says: The assets, a product of the accounting principles applied by US tax authorities to companies, are crucial to Citi's financial health. At the end of the second quarter, deferred tax assets made up more than a third of Citi's tangible equity – a measure of balance sheet strength.

The US bank has rebuffed calls to reserve for its DTAs – the biggest held by a US company – arguing that it will earn enough money in the future to justify keeping the assets on its books. Under accounting rules, Citi has to be confident it will earn $99bn in taxable income during the next two decades to avoid making provisions for DTAs. In the 2002–2006 periods Citi had annual pre-tax profits of at least $20bn.

However, some argue Citi is being too optimistic given its recent record – its pre-tax losses in 2008 and 2009 topped $60bn – and continued global economic uncertainty. Deferred tax calculation is at best a black art. In this case Citi says that because it has either losses it can carry forward or the benefit of allowances it has not yet claimed their cash value for tax purposes.

The most significant source of these timing differences is the loan loss reserve build, which accounts for approximately $15 billion of the net DTA. In general, Citi would need to generate approximately $86 billion of taxable income during the respective carry forward periods to fully realize its U.S. federal, state and local DTAs. Two generic things to note there first of all. Note that its clear future tax revenues from banks are going to be severely limited by the carry forward of tax losses. Second, note the injustice in this: those losses were already state funded.

Citigroup's ability to utilize its deferred tax assets (DTAs) to offset future taxable income may be significantly limited if it experiences an "ownership change" under the Internal Revenue Code.

As of December 31, 2009, Citigroup had recognized net DTAs of approximately $46.1 billion, which are included in its tangible common equity. Citigroup's ability to utilize its DTAs to offset future taxable income may be significantly limited if Citigroup experiences an "ownership change" as defined in Section 382 of the Internal Revenue Code of 1986, as amended (the Code). In general, an ownership change will occur if there is a cumulative change in Citigroup's ownership by "5-percent shareholders" (as defined in the Code) that exceeds 50 percentage points over a rolling three-year period.

The common stock issued pursuant to the exchange offers in July 2009, and the common stock and tangible equity units issued in December 2009 as part of Citigroup's TARP repayment, did not result in an ownership change under the Code. However, these common stock issuances have materially increased the risk that Citigroup will experience an ownership change in the future. On June 9, 2009, the Board of Directors of Citigroup adopted a Tax Benefits Preservation Plan. This Plan is subject to shareholders' approval at the 2010 Annual Meeting. The purpose of the Plan is to minimize the likelihood of an ownership change occurring for Section 382 purposes. Despite adoption of the Plan, future transactions in Citigroup stock that may not be in its control may cause Citigroup to experience an ownership change and thus limit its ability to utilize its DTAs, as well as cause a reduction in Citigroup's tangible common equity and stockholders' equity.

Source: Adapted from http://www.taxresearch.org.uk/Blog/2010/09/07/citis-deferred-tax-an-asset-of-dubious-worth/

14.3 Double Taxation Relief

Double taxation refers to a situation where the same income becomes taxable in the hands of the same company or individual (tax-payer) in more than one country. Such a situation arises due to different rules for taxation of income in different countries. If a person is resident of a country, he/she may have to pay tax on any income earned outside that country as well. Thus, the same person may be taxed in respect of his/her income on the basis of source of income rule in one country and on the basis of residence in another country leading to double taxation.

In the present era of cross-border transactions across the globe, the effect of taxation is one of the important considerations for any trade and investment decision in other countries. One of the most significant results of globalisation is the visible impact of one country's domestic tax policies on the economy of another country. This has led to the need for continuously assessing the tax regimes of various countries and bringing about necessary reforms. Where a taxpayer is resident in one country but has a source of income situated in another country it gives rise to possible double taxation. DTAAs lay down the rules for taxation of the income by the source country and the residence country. Such rules are laid for various categories of income, for example, interest, dividend, royalties, capital gains, business income etc. Each such category is dealt with by separate article in the DTAA.

14.3.1 Main Reasons for Double Taxation

The concept of Double Taxation comes into existence generally due to the following reasons:

1. A Company or a person may be resident of one country but may derive income from other country as well, thus he/she becomes taxable in both the countries.
2. A Company or a person may be subjected to tax on his/her world income in two or more countries, which is known as concurrent full liability to tax. One country may tax on the basis of nationality of tax-payer and another on the basis of his/her residence within its border. Thus, a person domiciled in one country and residing in another may become liable to tax in both the countries in respect of his/her world income.
3. A company or a person who is non-resident in both the countries may be subjected to tax in each one of them on income derived from one of them. For example, a non-resident person has a permanent establishment in one country and through it he/she derive income from the other country.

14.3.2 Rules due to which Double Taxation Arises

Double taxation means taxation of same income of a person in more than one country. This results due to countries following different rules for income taxation. There are two main rules of income taxation i.e.

(a) ***Source of income rule:*** Under which the income of a person is subjected to taxation in the country where the source of such income exists i.e. where the business establishment is situated or where the assets/property is located irrespective of whether the income earner is a resident in that country or not; and

(b) ***Residence rule:*** Under which the income earner is, taxed on the basis of his/her residential status in that country. Hence, if a person is resident of a country, he/she may have to pay tax on any income earned outside that country as well.

As per source of income rule, the income may be subject to tax in the country where the source of such income exists (i.e. where the business establishment is situated or where the asset/

property is located) whether the income earner is a resident in that country or not. On the other hand, the income earner may be taxed on the basis of his/her residential status in that country.

Example: If a person is resident of a country, he may have to pay tax on any income earned outside that country as well. Further, some countries may follow a mixture of the above two rules.

Thus problem of double taxation arise if a person is taxed in respect of any income on the basis of source of income rule in one country and on the basis of residence in other country or the basis of mixture of above two rules.

In India, the liability under the Income tax Act arises on the basis of the residential status of the assessee during the previous year. Hence, if the assessee is resident in India, he/she has to pay tax not only on the income which is received in India but also on that income which accrues, arises outside India or received outside India. Thus he/she become liable to pay double taxes. This puts unnecessary and prohibitive burden on the tax-payer. If the tax rates are sufficiently high, it may even leave him/her with a negative balance. It also has harmful effects on the trade and services as well as on movement of capital and people across countries. The relief against such double taxation in India has been provided under Section 90 and Section 91 of the Income Tax Act. They contain two ways of double taxation relief.

A condition in which two or more taxes may need to be paid for the same asset, financial transaction or income is known as double taxation. It generally takes place due to the overlapping of the tax laws and regulations of different countries. Thus, double taxation occurs when a taxpayer is charged income tax, both at his country of residence as well as in the country where the income is generated. Taking into account the laws of income tax in India, a non-resident becomes liable to tax payment in India, given that it is the place where the income is generated. Moreover, he has to additionally bear the burden of tax payment in his own country, by virtue of the inclusion of the same income in the 'total world income', which forms the tax base of the country where he resides.

Notes To effectively deal with the problems related to double taxation, Central Government, under Section 90 of the Income Tax Act of1961, has been certified to enter into Double Tax Avoidance Agreements (DTAA) with other countries. These agreements are meant to alleviate various problems related with double taxation. So far, India has entered into Double Taxation Avoidance Agreements with 65 countries, including U.S.A, Canada, U.K, Japan, Germany, Australia, Singapore, U.A.E and Switzerland. The tax treatises offers relaxation from double taxation, by providing release or by providing credits for taxes paid in one of the countries.

14.3.3 Types of Relief

Double taxation relief in India is of two type's Unilateral relief and Bilateral relief which are as follows:

1. ***Unilateral Relief:*** Under Section 91, Indian government can relieve an individual from burden of double taxation, irrespective of whether there is a DTAA between India and the other country concerned or not, under certain conditions. Cases where a person enjoys double taxation relief as per the unilateral relief scheme are:

   - If the person or company has been a resident of India in the previous year.

- If the person or company has paid income tax under the laws of the foreign country.
- The same income should be gained and received by the tax payer outside India in the previous year.
- The income should have been taxed in India and in a country with which India has no tax treaty.

2. ***Bilateral Relief:*** Under Section 90, Indian government provides protection against double taxation by entering into a mutually agreed tax treaty (DTAA) with another country. Under bilateral relief, protection against double taxation is provided either by completely avoidance of overlapping tax or waiving a certain amount of the tax payable in India. Such relief may be offered under two methods:
   - *Exemption method:* This ensures complete avoidance of tax overlapping.
   - *Tax credit method:* This provides relief by giving the tax payer a deduction from the tax payable in India.

14.3.4 Method of Giving Relief from Double Taxation

Relief from double taxation is provided by abatement on the basis of mutual agreement between two states concerned whereby the assessee is given relief by credit/refund in a particular manner even though he is taxed in both countries. Relief may be in the form of credit for tax payable in another country or by charging tax at lower rate.

The procedure to be adopted by the authorities for granting relief is to determine in the first place, the total income of the person liable to tax in India in accordance with the provisions of the Income-tax Act, and then allow relief as per the terms of the tax treaty entered with the other contracting country where the income has suffered double taxation.

Almost every treaty provides that the tax paid in the contracting country should be deducted from the tax payable by the assessee in the assessing country on the income taxable in both the countries. The treaty generally stipulates which country will grant relief and the manner and extent of the relief on the various heads of income.

Example: Income from immovable property is taxed in the source country where it is situated, but the country of residence of the owner can also tax the same income unless the tax treaty between the countries expressly provides for exclusion of the property income from being taxed in the country of residence of the assessee. Relief can, however, be claimed and given in terms of tax treaty on providing proof of payment or at least proof of assessment.

Relief cannot be granted unless the income which has been taxed in one of the contracting countries has also suffered tax in the other contracting country. Proof has to be provided of the income having suffered double taxation. If there is no tax treaty with the country levying double tax, then relief can be granted.

In case, one earns income which suffers tax outside India, the Income Tax Act has clear provision of relief from such double taxation. The relevant provisions are contained in section 90 and section 91 of the IT Act. Section 90 is applicable for the cases when the tax has been paid in a country with which India has signed comprehensive double taxation avoidance agreements. There are Double Taxation Avoidance Agreements with as many as 81 countries. Section 90(2) of the IT Act provides that the provision of the Income Tax Act shall apply in those cases where DTAAs signed, to the extent is more beneficial to the person. CBDT's circular No 333 dt 2.4.1998

[137 ITR 1 &2] clarified that whenever there is any conflict noticed on an issue between the provisions contained in both statutes, DTAA shall prevail over the statutory provision of the IT Act. In this regard, Supreme Court held that DTAA constitute special provisions which would prevail over general provision of the IT Act and effect must be given to the special provision of the DTAA even if they are in conflict with general provision of the IT Act.

In that case, section 91 of the IT Act provides relief from double taxation. Provision of Section 91 of the IT Act says

"If any person who is resident in India in any previous year proves that, in respect of his income which accrued or arose during that previous year outside India (and which is not deemed to accrue or arise in India), he has paid in any country with which there is no agreement under section 90 for the relief or avoidance of double taxation, income-tax, by deduction or otherwise, under the law in force in that country, he shall be entitled to the deduction from the Indian income-tax payable by him of a sum calculated on such doubly taxed income at the Indian rate of tax or the rate of tax of the said country, whichever is the lower, or at the Indian rate of tax if both the rates are equal".

Did u know? The general rules of computation of relief are as under:

1. Ascertain doubly taxed income.
2. Ascertain tax by applying Indian rate of tax as well as rate of foreign country separately.
3. Whichever is less, relief is given to that extent.

14.3.5 Taxation of Business Process Outsourcing Units in India

The provisions containing taxation of IT-enabled business process outsourcing units are not contained in the Income-tax Act, 1961 but are given in Circular No.5/2004 dated 28.9.2004 issued by CBDT. The provisions are briefed hereunder -

(a) A non-resident entity may outsource certain services to a resident Indian entity. If there is no business connection between the two, the resident entity may not be a Permanent Establishment of the non-resident entity, and the resident entity would have to be assessed to income-tax as a separate entity. In such a case, the non-resident entity will not be liable under the Income-tax Act, 1961.

(b) However, it is possible that the non-resident entity may have a business connection with the resident Indian entity. In such a case, the resident Indian entity could be treated as the Permanent Establishment of the non-resident entity.

(c) The non-resident entity or the foreign company will be liable to tax in India only if the IT enabled BPO unit in India constitutes its Permanent establishment.

(d) A non-resident or a foreign company is treated as having a Permanent Establishment in India if the said non-resident or foreign company carries on business in India through a branch, sales office etc. or through an agent (other than an independent agent) who habitually exercises an authority to conclude contracts or regularly delivers goods or merchandise or habitually secures orders on behalf of the non-resident principal. In such a case, the profits of the non-resident or foreign company attributable to the business activities carried out in India by the Permanent Establishment becomes taxable in India.

(e) If a foreign enterprise carries on business in another country through a Permanent Establishment situated therein, the profits of the enterprise may be taxed in the other country but only so much of them as are attributable to the Permanent Establishment.

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

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

(h) The expenses that are deductible would have to be determined in accordance with the accepted principles of accountancy and the provisions of the Income-tax Act, 1961.

(i) The profits to be attributed to a Permanent Establishment are those which that Permanent Establishment would have made if, instead of dealing with its Head Office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. This corresponds to the "arm's length principle".

(j) Hence, in determining the profits attributable to an IT-enabled BPO unit constituting a Permanent Establishment, it will be necessary to determine the price of the services rendered by the Permanent Establishment to the Head office or by the Head office to the Permanent Establishment on the basis of "arm's length principle".

14.3.6 Concept of Permanent Establishment

In order to determine the taxability of business income of foreign enterprises operating in India, it is important to determine the existence of a Permanent Establishment ('PE'). Article 5(1) of the DTAA provides that for the purpose of this convention the term 'Permanent Establishment' means a fixed place of business through which the business of an enterprise is wholly or partly carried on. The term 'Enterprise' has been defined in section 92F (iii).

According to Article 5(2), which enumerates various instances of PE, the term PE includes (a) a place of management; (b) a branch; (c) an office; (d) a factory; (e) a workshop; (f) a sales outlet; (g) a warehouse; (h) a mine, an oil or gas well, a quarry or other place of extraction of natural resources (but not exploration).

1. Permanent establishment means a fixed place of business through which the business of an enterprise is wholly or partly carried on.
2. Every DTAA has a specific clause, which will deal with an explanation of permanent establishment for the purpose of such DTAA.
3. Business Income of a non-resident will not be taxed in India, unless such non-resident has a permanent establishment in India.

Self Assessment

State whether the following statements are true or false:

9. Double taxation is a situation where the same income becomes taxable in the hands of the same company or individual (tax-payer) in more than one country.
10. Double taxation means taxation of same income of a person in less than one country.

11. Under Section 90, Indian government can relieve an individual from burden of double taxation.

12. Tax credit method provides relief by giving the tax payer a deduction from the tax payable in India.

14.4 Double Taxation Relief Provisions in India

Sections 90 and 91 of the Income tax Act, 1961 provide for double taxation relief in India. In India, a relief for avoidance of double taxation is provided in both ways that is Unilateral and Bilateral Relief. Provisions relating thereto are enumerated here in below:

1. Agreement with foreign countries or specified territories - Bilateral relief [Section 90]

   (i) Section 90(1) provides that the Central Government may enter into an agreement with the Government of any country outside India or specified territory outside India:

      (a) for the granting of relief in respect of:

         (i) income on which income-tax has been paid both in India and in that country or specified territory; or

         (ii) income-tax chargeable under this Act and under the corresponding law in force in that country or specified territory to promote mutual economic relations, trade and investment; or

      (b) for the avoidance of double taxation of income under this Act and under the corresponding law in force in that country or specified territory; or

      Accordingly, the Central Government has notified that where such an agreement provides that any income of a resident of India may be taxed in the other country then, such income shall be included in his total income chargeable to tax in India in accordance with the provisions of the Income-tax Act, 1961, and relief shall be granted in accordance with the method for elimination or avoidance of double taxation provided in such agreement [Notification No. 91/2008, dated 28.8.2008].

      (c) for exchange of information for the prevention of evasion or avoidance of income-tax chargeable under this Act or under the corresponding law in force in that country or specified territory or investigation of cases of such evasion or avoidance; or

      (d) for recovery of income-tax under this Act and under the corresponding law in force in that country or specified territory. The Central Government may by notification in the Official Gazette, make such provisions as may be necessary for implementing the agreement.

   (ii) Where the Central Government has entered into such an agreement with the Government of any country outside India or specified territory outside India for granting relief of tax, or for avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to that assessee.

   (iii) Any term used but not defined in this Act or in the agreement referred to above shall have the same meaning as assigned to it in the notification issued by the Central Government in the Official Gazette in this behalf, unless the context otherwise requires, provided the same is not inconsistent with the provisions of this Act or the agreement. The meaning assigned would be deemed to have come to effect from the date on which the said agreement came into force and not from the date of the said notification.

(iv) The DTAAs under section 90 are intended to provide relief to the taxpayer, who is resident of one of the contracting country to the agreement. Such tax payer can claim relief by applying the beneficial provisions of either the treaty or the domestic law. However, in many cases, taxpayers who were not residents of a contracting country also resorted to claiming the benefits under the agreement entered into by the Indian Government with the Government of the other country. In effect, third party residents claimed the unintended treaty benefits.

Therefore, sub-section (4) has been inserted in section 90 to provide that the non-resident to whom the agreement referred to in section 90(1) applies, shall be allowed to claim the relief under such agreement if a Tax Residence Certificate (TRC) obtained by him from the Government of that country or specified territory is furnished, containing such particulars as may be prescribed, declaring his residence of the country outside India or the specified territory outside India, as the case may be. The submission of TRC containing prescribed particulars shall be a necessary but not sufficient condition for availing benefits of the agreements referred to in these sections. In effect, further conditions can be stipulated for claiming treaty benefits, in addition to the requirement of submission of TRC.

(v) The charge of tax in respect of a foreign company at a rate higher than the rate at which a domestic company is chargeable, shall not be regarded as less favourable charge or levy of tax in respect of such foreign company.

However, the charge of tax in respect of a foreign company at a rate higher than the rate at which a domestic company is chargeable, shall not be regarded as less favourable charge or levy of tax in respect of such foreign company.

Caution However, the above mentioned position is likely to be changed as and when the General Anti-avoidance Rules (GAAR) becomes effective.

Notes **Models of Treaties**

Tax treaties are generally based on certain models. The most common ones are:

1. OECD model (Organisation of Economic Co-operation and Development) - Most of India's treaties are based on this model.
2. U.N. models Double Taxation Convention, 1980 between developed and developing countries.

2. Double taxation relief to be extended to agreements (between specified associations) adopted by the Central Government [Section 90A]

(i) Section 90A provides that any specified association in India may enter into an agreement with any specified association in the specified territory outside India and the Central Government may, by notification in the Official Gazette, make the necessary provisions for adopting and implementing such agreement for -

♦ grant of double taxation relief,

♦ avoidance of double taxation of income,

- exchange of information for the prevention of evasion or avoidance of income-tax, or
- recovery of income-tax.

Section 90A(1) provides that an agreement may be entered into by any specified association in India with any specified association in the specified territory outside India which may be adopted by the Central Government by way of notification in the Official Gazette, for granting relief of tax or, as the case may be, for avoidance of double taxation. The Central Government has, vide Notification No.90/2008 dated 28.8.2008, notified that where such an agreement provides that any income of a resident of India may be taxed in the other country then, such income shall be included in his total income chargeable to tax in India in accordance with the provisions of the Income-tax Act, 1961, and relief shall be granted in accordance with the method for elimination or avoidance of double taxation provided in such agreement.

(ii) In relation to any assessee to whom the said agreement applies, the provisions of the Income-tax Act, 1961 shall apply to the extent they are more beneficial to that assessee.

(iii) Any term used but not defined in the Income-tax Act, 1961 or in the said agreement shall have the same meaning as assigned to it in the said notification, unless the context requires otherwise, and it is not inconsistent with the provisions of the Act or the said agreement. The meaning assigned would be deemed to have come to effect from the date on which the said agreement came into force and not from the date of the said notification.

(iv) The DTAAs under section 90A are intended to provide relief to the taxpayer, who is resident of one of the contracting country to the agreement. Such tax payer can claim relief by applying the beneficial provisions of either the treaty or the domestic law. However, in many cases, taxpayers who were not residents of a contracting country also resorted to claiming the benefits under the agreement entered into by the Indian Government with the Government of the other country. In effect, third party residents claimed the unintended treaty benefits.

Therefore, sub-section (4) has been inserted in section 90A to provide that the non-resident to whom the agreement referred to in section 90A(1) applies, shall be allowed to claim the relief under such agreement if a Tax Residence Certificate (TRC) obtained by him from the Government of that country or specified territory is furnished, containing such particulars as may be prescribed, declaring his residence of the country outside India or the specified territory outside India, as the case may be. The submission of TRC containing prescribed particulars shall be a necessary but not sufficient condition for availing benefits of the agreements referred to in these sections. In effect, further conditions can be stipulated for claiming treaty benefits, in addition to the requirement of submission of TRC.

(v) The charge of tax at a higher rate for a company incorporated in the specified territory outside India as compared to a domestic company would not be considered as less favourable charge or levy of tax in respect of such company.

(vi) For the purpose of this section, the 'specified association' means any institution, association or body, whether incorporated or not, functioning under any law for the time being in force in India or the laws of the specified territory outside India and which may be notified as such by the Central Government and 'specified territory' means any area outside India which may be notified by the Central Government.

3. Countries with which no agreement exists - Unilateral Agreements [Section 91]

   In the case of income arising to an assessee in countries with which India does not have any double taxation agreement, relief would be granted under Section 91 provided all the following conditions are fulfilled:

   (i) The assessee is a resident in India during the previous year in respect of which the income is taxable.

   (ii) The income accrues or arises to him outside India.

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

   (iv) The income in question has been subjected to income-tax in the foreign country in the hands of the assessee

   (v) The assessee has paid tax on the income in the foreign country.

   (vi) There is no agreement for relief from double taxation between India and the other country where the income has accrued or arisen.

In such a case, the assessee shall be entitled to a deduction from the Indian income-tax payable by him. The deduction would be a sum calculated on such double tax income at the Indian rate of tax or the rate of tax in the said country, whichever is lower, or at the Indian rate of tax if both the rates are equal.

Sub-section (2) provides that where a person who is resident in India in any previous year has any agricultural income in Pakistan in respect of which he has paid the income tax payable in that country, he shall be entitled to a deduction from the Indian income-tax payable by him to the following extent:

(i) of the amount of tax paid in Pakistan on such income which is liable to tax under this Act, also; or

(ii) of a sum calculated on that income at the Indian rate of tax, whichever is less.

Sub-section (3) provides for relief to a non-resident assessee in respect of his share in the income of a registered firm assessed as resident in India in any previous year, provided all the following conditions are fulfilled –

(i) The share income from the firm should include income accruing or arising outside India during that previous year;

(ii) Such income should not be deemed to accrue or arise in India;

(iii) The income should accrue or arise in a country with which India has no agreement under section 90 for the relief or avoidance of double taxation; and

(iv) The assessee should have paid income-tax in respect of such income according to the law in force in that country.

In such a case, the assessee will be entitled to a deduction from the Indian income-tax payable by him. The deduction will be a sum calculated on such doubly taxed income so included, at the Indian rate of tax or the rate of tax of the said country, whichever is lower, or at the Indian rate of tax, if both the rates are equal.

Self Assessment

Fill in the blanks:

13. For exchange of information for the prevention of .... of income-tax chargeable under this Act or under the corresponding law in force in that country or specified territory or investigation of cases of such evasion or avoidance.

14. The ……………under section 90 are intended to provide relief to the taxpayer, who is resident of one of the contracting country to the agreement.
15. The charge of tax of a foreign company at a rate ……………….than the rate at which a domestic company is chargeable, shall not be regarded as less favourable charge or levy of tax in respect of such foreign company.
16. Sub-section (3) provides for relief to a …………………..assessee in respect of his share in the income of a registered firm assessed as resident in India in any previous year.

Case Study

Commissioner v. Indianapolis Power & Light Co.

Indianapolis Power & Light Company (IPL) required customers with suspect credit to make deposits with it to assure payment of future bills for electric service. IPL paid interest on deposits held for a certain period of time. A customer could obtain a refund prior to termination of service by making on time payments or by demonstrating acceptable credit. The refunds were normally made in cash or by check but a customer could also choose to have the deposit amount applied against future bills. Any deposit unclaimed after seven years would escheat to the State. At the time of receipt, IPL did not treat the deposits as income for tax purposes. The Internal Revenue Service (IRS) audited the utility and assessed a tax deficiency. IPL appealed this assessment to the United States Tax Court, which sided with IPL. This decision was then appealed, eventually reaching the Supreme Court.

In front of the Supreme Court, the IRS argued that the deposits were advance payments for electricity and therefore taxable to IPL in the year of receipt. In response, the utility stressed its obligation to refund the deposits with interest. IPL argued the payments were not taxable income because they were similar to loans.

To determine whether the deposits were income, the Supreme Court noted that "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion" constitute income. Commissioner v. Glenshaw Glass Co. The Court found that IPL did not enjoy "complete dominion" over the customer deposits; rather, the IPL had an express obligation to repay a deposit when a customer established good credit or terminated service. IPL's right to keep the money thus depended upon the customer's subsequent decision to have the deposit applied to future bills, not merely upon the utility's adherence to its contractual duties. As such IPL's dominion over the funds was far less than is ordinarily present in an advance payment situation.

The Court, in a unanimous decision, held that whether a payment constitutes income when received depends upon the rights and obligations of the parties at the time the payments are made. The ability to choose what happens to the deposit distinguishes a loan from an advance payment. An individual who makes an advance payment retains no right to insist upon the return of the funds. In contrast, the IPL utility customers retained the right to repayment. While a customer might apply the money to the purchase of electricity, he or she assumed no obligation to do so. Because the utility did not acquire unfettered "dominion" over the money, the deposits did not constitute income for tax purposes at the time of receipt.

Questions

1. Study and analyse the case.

Contd...

2. Write down the case facts.
3. What do you infer from it?

Source: Adapted from http://en.wikipedia.org/wiki/Commissioner_v._Indianapolis_Power_%26_Light_Co.

14.5 Summary

- Advance Payment of tax is another method of collection of tax by the Central Government in the Form of 'Prepaid Taxes'.
- Advance Tax can be deposited through Challan No. 280 in the Government Treasury (RBI) or any of the authorised branches of nationalised banks.
- Advance Tax is liable to be paid by all assesses like Salaried, Self Employed, Businessman etc. before the filing of Income Tax Return.
- Double taxation refers to a situation where the same income becomes taxable in the hands of the same company or individual (tax-payer) in more than one country.
- Double taxation arises from the two basic rules that enable the country of residence as well as the country where the source of income exists to impose tax namely, the source rule and the residence rule.
- DTAAs lay down the rules for taxation of the income by the source country and the residence country.
- In India, the liability under the Income tax Act arises on the basis of the residential status of the assessee during the previous year.
- Relief from double taxation is provided by abatement on the basis of mutual agreement between two states concerned whereby the assessee is given relief by credit/refund in a particular manner even though he is taxed in both countries.
- In order to determine the taxability of business income of foreign enterprises operating in India, it is important to determine the existence of a Permanent Establishment ('PE').
- Sections 90 and 91 of the Income tax Act, 1961 provide for double taxation relief in India.

14.6 Keywords

Advance Tax: Advance tax is the income tax payable if the person's tax liability exceeds ₹ 10,000 in a financial year. Advance tax should be pa

Assessee: As per Section 2(7) of Income Tax Act 1961 'assessee' is a person by whom any tax or any other sum of money is payable under the Act.

Bilateral Relief: In this the Governments of two countries can enter into an agreement to provide relief against double taxation by mutually working out the basis on which the relief is to be granted.

Business Process Outsourcing: The contracting out of a particular business function to an outside company in order to reduce costs.

Deferred Tax Liability: An account on a company's balance sheet is a result of temporary differences between the company's accounting and tax carrying values, the anticipated and enacted income tax rate, and estimated taxes payable for the current year.

Double Taxation: It refers to a situation where the same income becomes taxable in the hands of the same company or individual (tax-payer) in more than one country. Such a situation arises due to different rules for taxation of income in different countries.

Income Tax Return: A completed tax form, with details of income and allowances.

Income: The flow of cash or cash-equivalents received from work (wage or salary), capital (interest or profit), or land (rent).

Provisions: A legal clause or condition contained within a contract that requires or prevents either one or both parties to perform a particular requirement by some specified time.

Unilateral Relief: This method provides for relief of some kind by the home country even where no mutual agreement has been entered into by the two countries.

14.7 Review Questions

1. Discuss the concept of Advance Tax Payment with the help of example.
2. Who is liable to Pay Advance Tax? State whether Mr. Verma is liable to pay advance tax and if yes then what amount should be paid by what date. The income of Mr. X is ₹ 3,00,000.
3. Elucidate the procedure of computing Advance Tax Payment.
4. How to Deposit Advance Tax?
5. What are the consequences of non-payment of advance tax?
6. Define Double taxation. Highlight the rules due to which double taxation arises.
7. Describe the types of Double taxation relief.
8. Throw some light on the method of giving relief from Double Taxation.
9. Write a short note on Permanent Establishment.
10. Discuss the Double Taxation Relief Provisions in India.
11. An individual resident in India, having income earned outside India in a country with which no agreement under section 90 exists, asks you to explain whether the credit of the tax paid on the income in that country will be allowed to him in India.
12. The Income-tax Act, 1961 provides for taxation of a certain income earned by X. The Double Taxation Avoidance Agreement, which applies to X, excludes the income earned by X from the purview of tax. Is X liable to pay tax on the income earned by him? Discuss.

Answers: Self Assessment

1. True	2. False
3. True	4. False
5. Income Tax Return	6. Three
7. Individuals	8. Assesses
9. True	10. False
11. False	12. True
13. Evasion or Avoidance	14. DTAAs
15. Higher	16. Non-resident

14.8 Further Readings

Books

Aggarwal, K. *Direct Tax Planning and Management.* Atlantic Publications.

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Lakhotia, R. N. *Income Tax Planning Handbook.* Vision Books.

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Online links

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Address: N.H.-9, Delhi Road, Moradabad - 244001, Uttar Pradesh

Admission Helpline No. : 1800-270-1490

Contact No. :+ 91 9520 942111

Email : university@tmu.ac.in