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INCOME TAX LAW AND PRACTICE

M-231

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UNIT I

CHAPTER

1

BASIC CONCEPTS OF INCOME TAX

STRUCTURE

1.0 LEARNING OBJECTIVES

After going through this lesson you should be able to understand:

- discuss the meaning of Assessment year.
- define the meaning of Previous year.
- describe the word Assessee.
- understand, hold to charge tax on income.
- elucidate the meaning of income.
- define the meaning of gross total income.

1.1 MEANING OF ASSESSMENT YEAR

"Assessment year" means the period starting from April 1 and ending on March 31 of the next year.

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Example-Assessment year 2009-10 which will commence on April 1, 2009, will end on March 31, 2010.

Income of previous year of an assessee is taxed during the next following assessment year at the rates prescribed by the relevant Finance Act.

1.2 MEANING OF PREVIOUS YEAR

Income earned in a year is taxable in the next year. The year in which income is earned is known as previous year and the next year in which income is taxable is known as assessment year. In other words, previous year is the financial year immediately preceeding the assessment year.

Illustration 1.1: For the assessment year 2009-10, the immediately preceding financial year (i.e., 2008-09) is the previous year.

Income earned by an individual during the previous year 2008-09 is taxable in the immediately following assessment year 2009-10 at the rates applicable for the assessment year 2009-10.

Similarly, income earned during the previous year 2009-10 by a company will be taxable in the assessment year 2010-11 at the rates applicable for the assessment year 2010-11.

1.3 WHEN INCOME OF PREVIOUS YEAR IS NOT TAXABLE IN THE IMMEDIATELY FOLLOWING ASSESSMENT YEAR

The rule that the income of the previous year is taxable as the income of the immediately following assessment year has certain exceptions. These are:

(*a*) Income of non-residents from shipping;

(*b*) Income of persons leaving India either permanently or for a long period of time;

(*c*) Income of bodies formed for short duration;

(*d*) Income of a person trying to alienate his assets with a view to avoiding payment of tax; and

(*e*) Income of a discontinued business.

In these cases, income of a previous year may be taxed as the income of the assessment year immediately proceeding the normal assessment year. These exceptions have been incorporated in order to ensure smooth collection of income tax from the aforesaid taxpayers who may not be traceable if tax assessment procedure is postponed till the commencement of the normal assessment.

1.4 A FINANCIAL YEAR HAS A DOUBLE ROLE TO PLAY—IT IS A PREVIOUS YEAR AS WELL AS AN ASSESSMENT YEAR

On the basis of the aforesaid discussion, it can be said that a financial year plays a double role—it is a previous year as well as an assessment year.

1.5 PERSON

NOTES

The term "person" includes:

(a) an individual;
(b) a Hindu undivided family;
(c) a company;
(d) a firm;
(e) an association of persons or a body of individuals, whether incorporated or not;
(f) a local authority; and
(g) every artificial juridical person not falling within any of the preceding categories.

These are seven categories of persons chargeable to tax under the Act. The aforesaid definition is inclusive and not exhaustive. Therefore, any person, not falling in the above-mentioned seven categories, may still fall in the four corners of the term "person" and accordingly may be liable to tax.

1.6 ASSESSEE

"Assessee" means a person by whom income tax or any other sum of money is payable under the Act. It includes every person in respect of whom any proceeding under the Act has been taken for the assessment of his income or loss or the amount of refund due to him. It also includes a person who is assessable in respect of income or loss of another person or who is deemed to be an assessee, or an assessee in default under any provision of the Act.

1.7 HOW TO CHARGE TAX ON INCOME

To know the procedure for charging tax on income, one should be familiar with the following:

1. Annual tax—Income-tax is an annual tax on income..
2. Tax rate of assessment year—Income of previous year is chargeable to tax in the next following assessment year at the tax rates applicable for the assessment year. This rule is, however, subject to some exceptions.
3. Rates fixed by Finance Act—Tax rates are fixed by the annual Finance Act and not by the Income-tax Act. For instance, the Finance Act, 2006, fixes tax rates for the assessment year 2006-07.
4. Tax on person—Tax is charged on every person.
5. Tax on total income—Tax is levied on the "total income" of every assessee computed in accordance with the provisions of the Act.

1.8 MEANING OF INCOME

The definition of the term "income" in Section 2(24) is inclusive and not exhaustive. Therefore, the term "income" not only includes those things that are included in Section 2(24) but also includes those things that the term signifies according to its general and natural meaning.

1.9 GROSS TOTAL INCOME

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As per Section 14, the income of a person is computed under the following five heads:

1. Salaries.
2. Income from house property.
3. Profits and gains of business or profession.
4. Capital gains.
5. Income from other sources.

The aggregate income under these heads is termed as "gross total income". In other words, gross total income means total income computed in accordance with the provisions of the Act before making any deduction under sections 80C to 80U.

1.10 INCOME TAX RATES

ASSESSMENT YEAR 2009-2010 and 2010-2011

Individual/Huf	*Rate A.Y. 2009-2010*	*Individual/Huf*	*Rate A.Y. 2010-2011*
Up to 1,50,000	Nil	Up to 1,60,000	Nil
1,50,000 to 3,00,000	10%	1,60,000 to 3,00,000	10%
3,00,000 to 5,00,000	20% + 15000	3,00,000 to 5,00,000	20% + 14000
Above 5,00,000	30% + 55000	Above 5,00,000	30% + 54000

Resident Women < 65 Years	*Rate A.Y. 2009–2010*	*Resident Women < 65 Years*	*Rate A.Y. 2010–2011*
Up to 1,80,000	Nil	Up to 1,90,000	Nil
1,80,000 to 3,00,000	10%	1,90,000 to 3,00,000	10%
3,00,000 to 5,00,000	20% + 12000	3,00,000 to 5,00,000	20% + 11000
Above 5,00,000	30% + 52000	Above 5,00,000	30% + 51000

Senior Citizen of 65 Years or More	*Rate A.Y. 2009–2010*	*Senior Citizen of 65 Years or More*	*Rate A.Y. 2010–2011*
Up to 2,25,000	Nil	Up to 2,40,000	Nil
2,25,000 to 3,00,000	10%	2,40,000 to 3,00,000	10%
3,00,000 to 5,00,000	20% + 7500	3,00,000 to 5,00,000	20% + 6000
Above 5,00,000	30% + 47500	Above 5,00,000	30% + 46000

FIRM– 30% of Total Income.

COMPANY– 30% of Total Income.

ADVANCE TAX

Advance tax Limit increased from ₹ 5,000 to ₹ 10,000 from financial year 2009-10 onwards.

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FRINGE BENEFIT TAX

Fringe Benefit Tax not applicable from Assessment year 2010-11.

MAT (Minimum Alternate Tax)

Rate of Tax for MAT increased to 15% from the present rate of 10% W.e.f. A.Y. 2010-11 and MAT Credit to be carried forward up to tenth assessment year immediately succeeding the assessment year.

WEALTH TAX:

Rate of Tax is 1% on Net wealth exceeding ₹ 30,00,000 W.e.f. A.Y. 2010-2011.

SUMMARY

The lesson discusses in detail the meaning of various terms relevant for the purpose of studying income-tax in India. These terms are: assessment year, previous, person, assessee and income. In addition, the income-tax rates for the various categories of assess as are applicable to the assessment year *2009-10* is also enlisted in a tabular manner.

REVIEW QUESTIONS

1. Income of a previous year is chargeable tax in the immediately following assessment year. Is there any exception to this rule? Discuss.
2. Define the term "person".
3. How would you calculate income-tax for the assessment year 2009-10 in the case of different assesses?
4. Explain how surcharge on income-tax and education cess to applicable for the assessment year 2009-10?
5. X starts his business on April 26, 2008. Determine the previous year to the assessment year 2009-10?
6. Every financial year is a previous year as well as an assessment year. Discuss.

FURTHER READINGS

- *Income-tax Act, 1961,* Taxmann Publications Pvt. Ltd., New Delhi (latest edition).
- Singhania, Vinod. K. and Monica Singhania, *Students Guide to Income-tax,* Taxmann Publications Pvt. Ltd., New Delhi (latest edition).

UNIT II

CHAPTER

2

RESIDENTIAL STATUS AND TAX INCIDENCE

STRUCTURE

NOTES

2.0 LEARNING OBJECTIVES

After going through this lesson, you should be able to understand:

- the concept of residential status
- residential status of an Individual
- residential status of a Hindu Undivided Family
- residential status of a Firm and an Association of Persons
- residential status of a Company
- residential status of every other person
- residential status and incidence of Tax
- meaning of receipt and accrual of India
- meaning of income deemed to accrue or arise in India.

2.1 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. Similarly, whether an income earned by a foreign national in India (or outside India) is 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.

2.2 CONCEPT OF 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. Therefore, an individual and a Hindu undivided family can either be:

(*a*) resident and ordinarily resident in India; or
(*b*) resident but not ordinarily resident in India; or
(*c*) non-resident in India

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All other assessees (*viz.*, 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.

The table given below highlights these points:

Category	Individual/Hindu undivided family	Firm, association of persons, joint stock company and every other person
Category 1	Resident in India ➢ ***Ordinarily resident*** ➢ ***Not-ordinarily resident***	Resident in India
Category 2	Non-resident in India	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.

2.3 RESIDENTIAL STATUS OF AN INDIVIDUAL

As per Section 6, an individual may be

(*a*) resident and ordinarily resident in India,

(*b*) resident but not ordinarily resident in India, or

(*c*) non-resident in India.

2.3.1 Resident and Ordinarily Resident

As per Section 6(1), in order to find out whether an individual is "resident and ordinarily resident" in India, one has to proceed as follows—

Step 1. First find out whether such individual is "resident" in India.

Step 2. If such individual is "resident" in India, then find out whether he is "ordinarily resident" in India. However, if such individual is a "nonresident" in India, then no further investigation is necessary.

BASIC CONDITIONS TO TEST AS TO WHEN AN INDIVIDUAL IS RESIDENT IN INDIA—Under Section 6(1) an individual is said to be resident in

➢ Ordinarily resident

➢ Not-ordinarily resident

India in any previous year, if he satisfies at least one of the following basic conditions—

Basic condition (*a*) He is in India in the previous year for a period of 182 days or more.

Basic condition (*b*) *He is in India for a period of 60 days or more* during the previous year and 365 days or more during 4 years immediately preceding the previous year.

Note: In the following two cases, an individual needs to be present in India for a minimum of 182 days or more in order to become resident in India:

1. An Indian citizen who leaves India during the previous year for the purpose of taking employment outside India or an Indian citizen leaving India during the previous year as a member of the crew of an Indian ship.
2. An Indian citizen or a person of Indian origin who comes on visit to India during the previous year (a person is said to be of Indian origin if either he or any of his parents or any of his grand parents was born in undivided India).

ADDITIONAL CONDITIONS TO TEST AS TO WHEN A RESIDENT INDIVIDUAL IS ORDINARILY RESIDENT IN INDIA—Under Section 6(6),

Additional condition (*i*)	He has been resident in India in at least 2 out of 10 previous years [according to basic condition noted above] immediately preceding the *relevant previous year*.
Additional condition (*ii*)	He has been in India for a period of 730 days or more during 7 years immediately preceding the relevant previous year.

In brief it can be said that an individual becomes resident and ordinarily resident in India if he satisfies at least one of the basic conditions [*i.e.*, (*a*) or (*b*)] and the two additional conditions [*i.e.*, (*i*) and (*ii*)].

It will be worthwhile to note the following propositions:

1. It is not essential that the stay should be at the same place. It is equally not necessary that the stay should be continuous. Similarly, the place of stay or the purpose of stay is not material.
2. Where a person is in India only for a part of a day, the calculation *of physical presence in India in respect of* such broken period should be made on an hourly basis. A total of 24 hours of stay spread over a number of days is to be counted as being equivalent to the stay of one day. If, however, data is not available to calculate the period of stay of an individual in India in terms of hours, then the day on which he enters India as well as the day on which he leaves India shall be taken into account as stay of the individual in India.

2.3.2 Resident but not Ordinarily Resident

As per Section 6(1), an individual who satisfies at least one of the basic conditions [*i.e.*, condition (a) or (b) mentioned in Para 2.3.1a] but does not satisfy the two additional conditions [*i.e.*, conditions (i) and (ii) mentioned in Para 2.3.1b], is treated as a resident but not ordinarily resident in India. In other words, an individual becomes resident but not ordinarily resident in India in any of the following circumstances:

Case 1	If he satisfies at least one of the basic conditions [*i.e.*, condition (*a*) or (*b*)] but none of the additional conditions [*i.e.*, (*i*) and (*ii*)]
Case 2	If he satisfies at least one of the basic conditions [*i.e.*, condition (*a*) or (*b*)] and one of the two additional conditions [*i.e.*, (*i*) and (*ii*)]

2.4 NON-RESIDENT

An individual is a non-resident in India if he satisfies none of the basic conditions [*i.e.*, condition (*a*) or (*b*)]. In the case of non-resident, additional conditions [*i.e.*, (*i*) and (*ii*)] are not relevant.

Illustration 2.1: 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.

Solution: 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.

Illustration 2.2: X comes to India, for the first time, on April 16, 2003. During his stay in India up to October 5, 2005, he stays at Delhi up to April 10, 2005 and thereafter remains in Chennai till his departure from India. Determine his residential status for the assessment year 2006-07.

Solution: During the previous year 2005-06, X was in India for 188 days (*i.e.*, April 2005 : 30 days ; May 2005 : 31 days; June 2005 : 30 days ; July 2005 : 31 days ; August 2005 : 31 days ; September 2005 : 30 days and October 2005 : 5 days). He is in India for more than 182 days during the previous year and, thus, he satisfies condition (*a*) mentioned in Para 19.1-1. Consequently, he becomes resident in India. A resident individual is either ordinarily resident or not ordinarily resident.

To determine whether X is ordinarily resident or not, one has to test the two additional conditions as laid down by section 6(6) (*a*) [see conditions (*i*) and (*ii*).

Condition (i)—This condition requires that X should be resident in India in at least 2 years out of 10 years preceding the relevant previous year. X is resident in India for the previous years 2003-04 and 2004-05.

Condition (ii)—This condition requires that X should be in India for at least 730 days during 7 years immediately preceding the previous year. X is in India from April 16, 2003 to March 31, 2005 (*i.e.*, 716 days).

X satisfies one of the basic conditions and only one of the two additional conditions. X is, therefore, resident but not ordinarily resident in India for the assessment year 2006-07.

Note: In order to determine the residential status, it is not necessary that a person should continuously stay in India at the same place. Therefore, the information that X is in Delhi up to April 10, 2005 is irrelevant.

2.5 RESIDENTIAL STATUS OF A HINDU UNDIVIDED FAMILY

As per Section 6(2), a Hindu undivided family (like an individual) is either resident in India or non-resident in India. A resident Hindu undivided family is either ordinarily resident or not ordinarily resident.

2.5.1 HUF–Resident or Non-Resident

A Hindu undivided family is said to be resident in India if control and management of its affairs is wholly or partly situated in India. A Hindu undivided family is non-resident in India if control and management of its affairs is wholly situated outside India. Control and management means de facto control and management and not merely the right to control or manage. Control and management is situated at a place where the head, the seat and the directing power are situated.

2.5.2 HUF–When Ordinarily Resident in India

A resident Hindu undivided family is an ordinarily resident in India if the karta or manager of the family (including successive kartas) satisfies the following two additional conditions as laid down by section 6(6)(*b*):

Additional condition (i)	Karta has been resident in India in at least 2 out of 10 previous years [according to the basic condition immediately preceding the relevant previous year
Additional condition (ii)	Karta has been present in India for a period of 730 days or more during 7 years immediately preceding the previous year

If the karta or manager of a resident Hindu undivided family does not satisfy the two additional conditions, the family is treated as resident but not ordinarily resident in India.

2.6 RESIDENTIAL STATUS OF FIRM AND ASSOCIATION OF PERSONS

As per Section 6(2), a partnership firm and an association of persons are said to be resident in India if control and management of their affairs are wholly or partly situated within India during the relevant previous year. They are, however, treated as non-resident in India if control and management of their affairs are situated wholly outside India.

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2.7 RESIDENTIAL STATUS OF A COMPANY

As per Section 6(3), 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. However, a foreign company is treated as non-resident if, during the previous year, control and management of its affairs is either wholly or partly situated out of India.

2.8 RESIDENTIAL STATUS OF EVERY OTHER PERSON

As per Section 6(4), every other person is resident in India if control and management of his affairs is, wholly or partly, situated within India during the relevant previous year. On the other hand, every other person is non-resident in India if control and management of its affairs is wholly situated outside India.

2.9 RESIDENTIAL STATUS AND INCIDENCE OF TAX

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.

2.9.1 Indian and Foreign Income

In order to understand the relationship between residential status and tax liability, one must understand the meaning of "Indian income" and "foreign income".

"INDIAN INCOME"—Any of the following three is an Indian income—

1. 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.
2. 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.
3. 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.

FOREIGN INCOME—If the following two conditions are satisfied, then such income is "foreign income" —

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

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

Illustration 2.3: The above provisions may be explained in brief as follows:

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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

2.9.2 Incidence of Tax for Different Taxpayers

	Individual and Hindu Undivided Family		
	Resident and ordinarily resident in India	*Resident but not Ordinarily resident in India*	*Non-resident in India*
➢ **Indian income**	Taxable in India	Taxable in India	Taxable in India
➢ **Foreign income**			
- If it is business income and business is controlled wholly or partly from India	Taxable in India	Taxable in India	Not Taxable in India
- If it is income from profession which is set up in India	Taxable in India	Taxable in India	Not Taxable in India
- If it is business income and business is controlled from outside India	Taxable in India	Not Taxable in India	Not Taxable in India
- If it is income from profession which is set up outside India	Taxable in India	Not Taxable in India	Not Taxable in India
- Any other foreign income (like salary, rent, interest, etc.)	Taxable in India	Not Taxable in India	Not Taxable in India

Any other taxpayer (like company, firm, co-operative society, association of persons, body of individual, etc.

	Resident in India	*Non-resident in India*
Indian income	Taxable in India	Taxable in India
Foreign income	Taxable in India	Not Taxable in India

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2.10 MEANING OF RECEIPT OF INCOME

Income received in India is taxable in all cases irrespective of the residential status of an assessee. The following points are worth mentioning in this respect:

2.10.1 Receipt vs. Remittance

The "receipt" of income refers to the first occasion when the recipient gets the money under his control. Once an amount is received as income, any remittance or transmission of the amount to another place does not result in "receipt" at the other place.

2.10.2 Actual Receipt vs. Deemed Receipt

It is not necessary that an income should be actually received in India in order to attract tax liability. An income deemed to be received in India in the previous year is also included in the taxable income of the assessee. The Act enumerates the following as income deemed to be received in India:

- Interest credited to recognized provident fund account of an employee in excess of 9.5 per cent.
- Excess contribution of employer in the case of recognized provident fund (*i.e.,* the amount contributed in excess of 12 per cent of salary).
- Transfer balance.
- Contribution by the Central Government to the account of an employee under a pension scheme referred to in section 80CCD.
- Tax deducted at source.
- Deemed profit under section 41.

2.11 MEANING OF ACCRUAL OF INCOME

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.

2.12 MEANING OF INCOME DEEMED TO ACCRUE OR ARISE IN INDIA

In some cases, income is deemed to accrue or arise in India under Section 9 even though it may actually accrue or arise outside India. Section 9 applies to all assessees irrespective of their residential status and place of business. The categories of income which are deemed to accrue or arise in India are as under:

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*	
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
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 anyother 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 resident in India	Payment is relatable to a business or profession or anyother 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

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Illustration 2.1: 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.

Solution: 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.

SUMMARY

The lesson discusses in detail the meaning of the term residential status as incidence of tax depends upon this status of the assessee. The residential status of individual, Hindu undivided family, firm association of persons, company and every other person are analysed. In addition the concept of Indian income and foreign income has also been dealt with so as to give a complete picture to the students of the income, which is liable to be taxed in India according to the residential status.

REVIEW QUESTIONS

1. How is residential status determined?
2. What are the different categories of residential status? Explain how these categories are determined and affect the tax liability of an assessee?
3. "The incidence of income-tax depends upon the residential status of an assessee". Discuss fully.
4. Write short notes on the following:
   (*a*) Income received in India
   (*b*) Income deemed to accrue or arise in India
   (*c*) Control and management of a business

5. 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?
6. X, a *foreign citizen*, visits India *since* 1985 every year for a period of 100 days. Determine the residential status of X for the assessment year 2006-07?

FURTHER READINGS

- *Income-tax Act, 1961*, Taxmann Publications Pvt. Ltd., New Delhi (latest edition).
- Singhania, Vinod. K. and Monica Singhania, *Students Guide to Income-tax*, Taxmann Publications Pvt. Ltd., New Delhi (latest edition).

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CHAPTER

3

INCOME EXEMPT FROM TAX

STRUCTURE

3.0 LEARNING OBJECTIVES

After going through this lesson, you should be able to understand the various incomes which are exempt from tax.

3.1 INTRODUCTION

However, every income is taxable under income tax law, whether it is received in cash or in kind, whether it is capital or revenue income, but still some incomes are given exemption from tax. In this lesson we will study those incomes which are exempt from tax.

3.2 INCOME EXEMPT FROM TAX UNDER SECTION 10

However, every income is taxable under income tax law, whether it is received in cash or in kind, whether it is capital or revenue income, but still some incomes are given exemption from tax. In this lesson we will study those incomes which are exempt from tax. In the following cases, income is absolutely exempt from tax, as it does not form part of total income. The burden of proving that a particular item of income falls within this Section is on the assessee.

3.3 AGRICULTURAL INCOME

As per Section 10(1), agricultural income is exempt from tax if it comes within the definition of "agricultural income" as given in Section 2(1A). In some cases, however, agricultural income is taken into consideration to find out tax on non-agricultural income.

3.4 RECEIPTS BY A MEMBER FROM A HINDU UNDIVIDED FAMILY

As per Section 10(2), any sum received by an individual as a member of a Hindu undivided family either out of income of the family or out of income of estate belonging to the family is exempt from tax. Such receipts are not chargeable totax in the hands of an individual member even if tax is not paid or payable by the family on its total income.

Illustration 1: X, an individual, has personal income of ₹ 56,000 for the previous year 2008-09. He is also a member of a Hindu undivided family, which has an income of ₹ 1,08,000 for the previous year 2005-06. Out of income of the family, X gets ₹ 12,000, being his share of income. ₹ 12,000 will be exempt in the hands of X by virtue of Section 10(2). The position will remain the same whether (or not) the family is chargeable to tax. X shall pay tax only on his income of ₹ 56,000.

3.5 SHARE OF PROFIT FROM PARTNERSHIP FIRM

As per Section 10(2A), share of profit received by partners from a firm is not taxable in the hand of partners.

NOTES

3.6 CASUAL AND NON-RECURRING INCOME

This exemption is not available from the assessment year 2003-04.

3.7 LEAVE TRAVEL CONCESSION

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 is exempt. Exemption is available in respect of travel fare only and also with respect to the shortest route.

3.8 FOREIGN ALLOWANCE

As per Section 10(7), any allowance paid or allowed outside India by the Government to an Indian citizen for rendering service outside India is wholly exempt from tax.

3.9 TAX ON PERQUISITE PAID BY EMPLOYER

As per Section 10(10CC), 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.

3.10 AMOUNT PAID ON LIFE INSURANCE POLICIES

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.

In respect of (*c*) (supra) the following points should be noted—

1. Any sum received under such policy on the death of a person shall continue to be exempt.
2. 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.

3.11 EDUCATIONAL SCHOLARSHIPS

As per Section 10(16), scholarship granted to meet the cost of education is exempt from tax. In order to avail the exemption it is not necessary that the Government should finance scholarship.

3.12 DAILY ALLOWANCES OF MEMBERS OF PARLIAMENT

Clause (17) of Section 10 provides exemption to Members of Parliament and State Legislature in respect of the following allowances:

Case	*Nature of allowance*	*How much is exempt*
Case 1	Daily allowance	Entire amount is exempt
Case 2	Any other allowance received by a Member of Parliament under the *Members of Parliament* (Constituency Allowance) Rules, 1986	Entire amount is exempt
Case 3	All allowances received by any person by reason of his membership of any State Legislature or any Committee there of	Up to ₹ 2,000 per month in aggregate

3.13 FAMILY PENSION RECEIVED BY MEMBERS OF ARMED FORCES

As per Section 10(19), family pension received by the widow (or children or nominated heirs) of a member of the armed forces (including para-military forces) of the Union is not chargeable to tax from the assessment year 2005-06, if death is occurred in such circumstances given below—

(*a*) acts of violence or kidnapping or attacks by terrorists or anti-social elements;

(*b*) action against extremists or anti-social elements;

(*c*) enemy action in the international war;

(*d*) action during deployment with a peace keeping mission abroad;

(*e*) border skirmishes;

(*f*) laying or clearance of mines including enemy mines as also mine sweeping operations;

(*g*) explosions of mines while laying operationally oriented mine-fields or lifting or negotiation mine-fields laid by the enemy or own forces in operational areas near international borders or the line of control;

(*h*) in the aid of civil power in dealing with natural calamities and rescue operations; and

(i) in the aid of civil power in quelling agitation or riots or revolts by demonstrators.

NOTES

3.14 INCOME OF MINOR

As per Section 10(32), in case the income of an individual includes the income of his minor child in terms of Section 64(1A), such individual shall be entitled to exemption of ₹ 1,500 in respect of each minor child if the income of such minor as includible under Section 64(1A) exceeds that amount. Where, however, the income of any minor so includible is less than ₹ 1,500, the aforesaid exemption shall be restricted to the income so included in the total income of the individual.

3.15 CAPITAL GAIN ON TRANSFER OF US-64

As per Section 10(33), any income arising from the transfer of a capital asset being a unit of US-64 is not chargeable to tax where the transfer of such assets takes place on or after April 1, 2002. This rule is applicable whether the capital asset (US-64) is long-term capital asset or short-term capital asset. If income from a particular source is exempt from tax, loss from such source cannot be set off against income from another source under the same head of income. Consequently, loss arising on transfer of units of US-64 cannot be set off against any income in the same year in which it is incurred and the same cannot be carried forward.

3.16 DIVIDENDS AND INTEREST ON UNITS

As per Section 10(34)/(35), the following income is not chargeable to tax—28

(a) any income by way of dividend referred to in Section 115-O [*i.e.*, dividend, not being covered by Section 2(22) (e), from a domestic company];

(b) any income in respect of units of mutual fund;

(c) income from units received by a unit holder of UTI [*i.e.*, from the administrator of the specified undertaking as defined in Unit Trust of India (Transfer of Undertaking and Repeal) Act, 2002];

(d) income in respect of units from the specified company.

3.17 CAPITAL GAIN ON COMPULSORY ACQUISITION OF URBAN AGRICULTURAL LAND

As per Section 10(37), in the case of an individual/Hindu undivided family, capital gain arising on transfer by way of compulsory acquisition of urban agricultural land is not chargeable to tax from the assessment year 2005-06 if such compensation is received after March 31, 2004 and the agricultural land was used by the assessee (or by any of his parents) for agricultural purposes during 2 years immediately prior to transfer.

3.18 LONG-TERM CAPITAL GAINS ON TRANSFER OF EQUITY SHARES/UNITS IN CASES COVERED BY SECURITIES TRANSACTION TAX

As per Section 10(38), Long-term capital gains arising on transfer of equity shares or units of equity oriented mutual fund is not chargeable to tax from the assessment year 2005-06 if such a transaction is covered by securities transaction tax.

The securities transaction tax is applicable if equity shares or units of equity oriented mutual fund are transferred on or after October 1, 2004 in a recognized stock exchange in India (or units are transferred to the mutual fund). If the securities transaction tax is applicable, long-term capital gain is not chargeable to tax; short-term capital gain is taxable @ 10 per cent (plus SC and EC). If income is shown as business income, the taxpayer can claim rebate under Section 88E.

SUMMARY

The lesson discusses in brief few selected income, which are exempt from income-tax in India. The few important in today age include agricultural income, income of minor, family pension; leave travel commission and dividend income.

REVIEW QUESTIONS

1. Name any five incomes which are exempt from tax.
2. Explain briefly the exemption from income-tax available in the case of a minor child.
3. Discuss the exemption with respect to agricultural income from India.
4. Explain briefly the exemption from income-tax available in the case of dividend income received from an Indian company.

FURTHER READINGS

- *Income-tax Act, 1961*, Taxmann Publications Pvt. Ltd., New Delhi (latest edition).
- Singhania, Vinod. K. and Monica Singhania, *Students Guide to Income-tax*, Taxmann Publications Pvt. Ltd., New Delhi (latest edition).

NOTES

UNIT III

CHAPTER

4

INCOME FROM SALARY [PART–I]

STRUCTURE

4.0 LEARNING OBJECTIVES

After going through this lesson, you should be able to understand:

- classification of income into various heads
- concept of salary income
- incomes forming part of salary
- the computation of basic salary in grade system
- types of commission an employee can get
- the concept of allowances
- various income tax provisions for computing taxable value of allowances
- computation of taxable value of allowances.

4.1 INTRODUCTION

As discussed in an earlier lesson, income means a receipt in the form of money or money's worth which is derived from definite source with some sort of regularity or expected regularity. These definite sources of income are salaries, house property, business or profession, capital gains and any other source. If an income is not derived from any of these sources, it is not taxable under the Income Tax Act, 1961 (hereinafter referred as 'Act'). For example, if a person finds a purse containing ₹ 1000 on road, it is not treated as income since it is not received from any definite source.

We have also learnt that scope of total income is determined with reference to residential status of a person *i.e.* total income of each person is based on his residential status. Once we know what incomes of a person are taxable, then we need to know how to compute total taxable income according to the provisions of Income Tax Act.

The present lesson starts with the classification of incomes into various heads. A detailed study of these heads of income is made lesson wise. This lesson is devoted to the first and most important head of income "Salaries". The lesson is divided into various sections. First we define the concept of salary income *i.e.* what are the characteristics, which make an income fall under this head. Then, incomes falling under this head are enumerated, followed by the detailed descriptions of income tax provisions regarding three of these incomes. The description of remaining two incomes forming part of salary will be covered in the next lesson along with procedure for computation of salary income. Finally, all the provisions covered in this lesson are summarized for the sake of convenience.

4.2 HEADS OF INCOME

Income of a person is classified into 5 categories. Thus, income belonging to a particular category is taxed under a separate head of income pertaining to that category. Section 14 of the Act, has classified five different heads of income for the purpose of computation of total income. The five heads of income are:

1. Income under the head salaries (Section 15–17)
2. Income from house property (Section 22–27)
3. Profits and gains from business or profession (Section 28–44)
4. Capital gains (Section 45–55)
5. Income from other sources (Section 56–59)

It may be noted here that an income belonging to a specific head must be computed under that head only. If an income cannot be placed under any of the first four heads, it will be taxed under the head "Income from other sources". Certain expenses incurred in earning incomes under each head are allowed to be deducted from its gross income according to the provisions applicable to that specific head. Then, the net income under various heads is aggregated together to compute gross total income of the person. After making certain deductions which are allowed from gross total income (relating to certain expenses incurred or payments made or certain incomes earned) we arrive at the figure of total income for taxation purpose.

4.3 MEANING OF SALARY

NOTES

Salary, in simple words, means remuneration of a person, which he has received from his employer for rendering services to him. But receipts for all kinds of services rendered cannot be taxed as salary. The remuneration received by professionals like doctors, architects, lawyers etc. cannot be covered under salary since it is not received from their employers but from their clients. So, it is taxed under business or profession head. In order to understand what is included in salary, let us discuss few characteristics of salary.

Characteristics of Salary

1. The relationship of payer and payee must be of employer and employee for an income to be categorized as salary income. For example: Salary income of a Member of Parliament cannot be specified as salary; since it is received from Government of India which is not his employer.
2. The Act makes no distinction between salary and wages, though generally salary is paid for non-manual work and wages are paid for manual work.
3. Salary received from employer, whether one or more than one is included in this head.
4. Salary is taxable either on due basis or receipt basis which ever matures earlier:
   (*i*) **Due basis**–when it is earned even if it is not received in the previous year.
   (*ii*) **Receipt basis**–when it is received even if it is not earned in the previous year.
   (*iii*) **Arrears of salary**–which were not due and received earlier are taxable when due or received, which ever is earlier.
5. Compulsory deduction from salary such as employees' contribution to provident fund, deduction on account of medical scheme or staff welfare scheme etc. are examples of instances of application of income. In these cases, for computing total income, these deductions have to be added back.

4.4 INCOMES FORMING PART OF SALARY-I

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*).

4.4.1 Basic Salary

All employees are entitled to a basic salary which is fixed as per their respective terms of employment either as a fixed amount or at a graded system of salary. Under this graded system, apart from the basic salary at which the employee will start, annual increments to be given to the employee are pre fixed in the grade.

For example, if a person is employed on 1st May, 2004 in the grade of 12000 – 300 – 15000, this means that he will start at a basic salary of ₹ 12000 from 1st May, 2004. He will get an annual increment of ₹ 300 w.e.f. 1st May, 2005 and onwards every year on the same date till his basic salary reaches ₹ 15, 000. No further increment is given thereafter till he is promoted and placed in other grade. Advance Salary, if received in previous year for next year is taxable on receipt basis in the same previous year.

Illustration 4.1

X joins service in the grade of ₹ 12000–300–13800–400–17800 on 1st June, 1999. Compute his basic salary for the previous year 2005-06.

Solution:

For the previous year 2005-06, basic salary of X will be calculated as follows:

1st June 1999–31st May 2000 12000 1st June 2003–31st May 2004 13200

1st June 2000–31st May 2001 12300 1st June 2004–31st May 2005 13500

1st June 2001–31st May 2002 12600 1st June 2005–31st May 2006 13800

1st June 2002–31st May 2003 12900

Basic Salary for April and May 2005 (₹ 13500 × 2) 27,000

Basic Salary for June 2005–March 2006 (₹ 13800 × 10) 1, 38,000

Basic Salary for previous year 1, 65,000

4.4.2 Fees, Commission and Bonus

Any fees or commission paid or payable to an employee is fully taxable and is included in salary. Commission payable may be at a fixed amount or a fixed percentage of turnovers. In both the cases, it is taxable as salary only when it is paid or payable by the employer to the employee. When commission is based on fixed percentage of turnover achieved by employee, it is included in basic salary for the purpose of grant of retirement benefits and for computing certain exemptions that we will discuss later on.

4.4.3 Taxable Value of Allowances

Allowance is a fixed monetary amount paid by the employer to the employee (over and above basic salary) for meeting certain expenses, whether personal or for the performance of his duties. These 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 3 categories:

I. Fully taxable cash allowances
II. Partially exempt cash allowances
III. Fully exempt cash allowances

I. Fully Taxable Cash 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 main allowances under this category are enumerated below:

(*i*) **Dearness Allowance and Dearness Pay:** As is clear by its name, this allowance is paid to compensate the employee against the rise in price level in the economy. Although it is a compensatory allowance against high prices, the whole of it is taxable. When a part of Dearness Allowance is converted into Dearness Pay, it becomes part of basic salary for the grant of retirement benefits and is assumed to be given under the terms of employment.

(*ii*) **City Compensatory Allowance:** This allowance is paid to employees who are posted in big cities. The purpose is to compensate the high cost of living in cities like Delhi, Mumbai etc. However, it is fully taxable.

(*iii*) **Tiffin/Lunch Allowance:** It is fully taxable. It is given for lunch to the employees.

(*iv*) **Non practicing Allowance:** This is normally given to those professionals (like medical doctors, chartered accountants etc.) who are in government service and are banned from doing private practice. It is to compensate them for this ban. It is fully taxable.

(*v*) **Warden or Proctor Allowance:** These allowances are given in educational institutions for working as a Warden of the hostel or as a Proctor in the institution. They are fully taxable.

(*vi*) **Deputation Allowance:** When an employee is sent from his permanent place of service to some place or institute on deputation for a temporary period, he is given this allowance. It is fully taxable.

(*vii*) **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.

(*viii*) **Fixed Medical Allowance:** Medical allowance is fully taxable even if some expenditure has actually been incurred for medical treatment of employee or family.

(*ix*) **Servant Allowance:** It is fully taxable whether or not servants have been employed by the employee.

(*x*) **Other allowances:** There may be several other allowances like family allowance, project allowance, marriage allowance, education allowance, and holiday allowance etc. which are not covered under specifically exempt category, so are fully taxable.

II. Partially Exempt Cash 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.

(*i*) **House Rent Allowance (H.R.A.):** An allowance granted to a person by his employer to meet expenditure incurred on payment of rent in respect of residential accommodation occupied by him is exempt from tax to the extent of least of the following three amounts:

(*a*) House Rent Allowance actually received by the assessee

(*b*) Excess of rent paid by the assessee over 10% of salary due to him

(*c*) An amount equal to 50% of salary due to assessee (If accommodation is situated in Mumbai, Kolkata, Delhi, Chennai) 'Or' an amount equal to 40% of salary (if accommodation is situated in any other place).

Salary for this purpose includes Basic Salary, Dearness Allowance (if it forms part of salary for the purpose of retirement benefits), Commission based *on fixed percentage of turnover achieved by the employee.*

The exemption of HRA depends upon the following factors:

1. Basic Salary
2. Place of residence
3. Rent paid
4. HRA received

If an employee is living in his own house and receiving HRA, it will be fully taxable.

Illustration 4.2

Mr. X is employed in A Ltd. getting basic pay of ₹ 20, 000 per month and dearness allowance of ₹ 7, 000 per month (half of the dearness allowance forms part of salary for the purpose of retirement benefits). The employer has paid bonus @ ₹ 500 per month, Commission @1% on the sales turnover of ₹ 20 lakhs, and house rent allowance of ₹ 6, 000 per month. X has paid rent of ₹ 7,000 per month and was posted at Agra. Compute his gross salary for the assessment year 2009-10.

Solution:

Computation of Gross Salary Amount/₹

Basic Salary (₹ 20,000 × 12) 2,40,000

Dearness Allowance (₹ 7,000 × 12) 84,000

Bonus (₹ 500 × 12) 6,000

Commission (1% of ₹ 20,00,000) 20,000

House Rent Allowance

(₹ 6,000 × 12 – Amount exempt ₹ 53,800)

18,200

Gross Salary: 3,68,200

Amount of HRA exempt is least of 3 amounts:

1. 40% of Salary (₹ 2,40,000 + ₹ 42,000 + ₹ 20,000) = ₹ 3,02,000
2. Actual HRA received (₹ 6,000 × 12) = ₹ 72,000
3. Rent paid (₹ 7,000 × 12 – 10% of salary ₹ 30,200) = ₹ 53,800

Amount of HRA exempt is = ₹ 53,800.

(*ii*) **Entertainment Allowance:** This allowance is first included in gross salary under allowances and then deduction is given to only central and state government employees under Section 16 (ii).

(*iii*) **Special Allowances for meeting official expenditure:** Certain allowances are given to the employees to meet expenses incurred exclusively in performance of official duties and hence are exempt to the extent actually incurred for the purpose for which it is given. These include travelling allowance, daily allowance, conveyance allowance, helper allowance, research allowance and uniform allowance.

(*iv*) **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 (grandchildren are not considered).

(*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 ₹ 1600 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 ₹ 6000 per month, whichever is less.

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III. Fully Exempt Cash Allowances

(i) **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.

(ii) Allowance to High Court and Supreme Court Judges of whatever nature are exempt from tax.

(iii) Allowances from UNO organisation to its employees are fully exempt from tax.

Illustration 4.3 (Based on different allowances received by employee)

From the following particulars, compute gross salary of Mr X for the assessment year 2009-10. He is employed in textile industry in Mumbai at a monthly salary of ₹ 4000. 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 ₹ 2000 per month which is granted under terms of employment and counted for retirement benefits.
2. Bonus ₹ 32000
3. House Rent Allowance ₹ 1000 per month (Rent paid for house in Mumbai ₹ 1200 per month)
4. Entertainment Allowance ₹ 1000 per month
5. Children Education Allowance ₹ 500 per month
6. Transport Allowance ₹ 1000 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 ₹ 3000)

Solution:

Computation of Income from Salary of Mr. X for the Assessment Year 2009-10

Amount	₹
Basic Salary	48,000
Dearness Allowance	24,000
Commission	10,000
Bonus	32,000
House Rent Allowance	
(₹ 1000 × 12 – Amount exempt ₹ 6200)*5,800	
Entertainment Allowance	12,000
Children Education Allowance	
(₹ 500 × 12 – Amount exempt ₹ 100 × 2 × 12)	3,600
Transport Allowance	
(₹ 1000 × 12 – Amount exempt ₹ 800 × 12)	2,400

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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 ₹ 3000)	3,000

Gross Salary: 152,800

* 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

SUMMARY

1. Heads of Income: There are 5 heads of income into which income of persons can be divided namely Income from salary, house property, business or profession, capital gains and other sources.
2. Meaning of Salary: Any remuneration paid by an employer to an employee in consideration of his services is called salaries. It includes monetary value of those benefits and facilities, which are provided by the employer and are taxable.
3. Income forming part of salary: They include basic salary, advance salary, fees, commission, bonus, taxable value of cash allowances, perquisites and retirement benefits.
4. Allowances: These are of three types:
   (*a*) Taxable Allowances: Dearness allowance, Medical allowance, Servant allowance, Warden Allowance, Family allowance, City Compensatory allowance etc.
   (*b*) Allowances exempt upto specified limit: House rent allowances, Entertainment allowance, Certain Special allowances, etc.
   (*c*) Fully exempted allowances: Foreign allowance, sumptuary allowance to High Court / Supreme Court Judges, Allowances from U.NO.

REVIEW QUESTIONS

1. Mr. X is employed in P Ltd. getting basic pay of ₹ 20,000 per month. The employer has paid him the following emoluments:
   Rupees Bonus 6,000 per annum
   Servant Allowance 500 per month
   Project Allowance 1000 per month
   Lunch Allowance 300 per month
   Transport Allowance 900 per month
   Deputation Allowance 1000 per month
   Children Education Allowance (for 3 children) 400 per month
   House Rent Allowance (He is living in his own house) 1000 per month
   Compute his gross salary for the assessment year 2009-10:

NOTES

Hints: 1. HRA is fully taxable
2. Children education allowance is exempt to the extent of ₹ 100 per month per child for maximum 2 children
3. Transport allowance is exempt to the extent of ₹ 800 per month

2. Mr. X is employed in A Ltd. getting basic pay of ₹ 11,000 per month, dearness allowance ₹ 4,000 per month and commission of ₹ 10,000. Employer has paid children education allowance ₹ 500 per month per child for 3 children. The employee has paid hostel allowance ₹ 800 per month for 1 child and employer incurred ₹ 2000 per month for the same. Employer also paid transport allowance of ₹ 900 per month (X spent ₹ 700 per month on it) and house rent allowance of ₹ 4, 000 per month. The employee paid rent of ₹ 2500 per month. Compute his gross salary for the assessment year 2009-10:

Hints: 1. Hostel allowance is exempt up to ₹ 300 per month
2. Dearness allowance is not forming part of salary for retirement benefits, so will not be included in computing exemption for HRA.
3. Since place of residence is not given; we assume it is not metro city.

3. 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, 2006. 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, 2009.

Compute his gross salary for assessment year 2009-10:

Hints: 1. Part of Dearness Allowance will be included in computing exemption for HRA.
2. Commission based on fixed percentage of turnover will also be included.
3. Salary for only 11 months will be included in Gross Salary.

FURTHER READINGS

- *Income-tax Act, 1961*, Taxmann Publications Pvt. Ltd., New Delhi (Latest edition).
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- Ahuja Girish and Ravi Gupta (2006), *Systematic Approach to Income Tax and Sales Tax*, Bharat Publication, Sahitya Bhawan, Agra.
- Chandra Mahesh and D.C. Shukla (2006), *Income Tax Law and Practice*, Pragati Publication, New Delhi.
- Mehrotra H.C. (2006), *Income Tax Law and Accounts*, Sahitya Bhawan, Agra.

CHAPTER

5

INCOME FROM SALARY [PART–II]

STRUCTURE

5.0 LEARNING OBJECTIVES

After going through this lesson, you should be able to understand:

- concept of perquisites
- classification of perquisites for their tax treatment
- valuation of perquisites
- various kinds of retirement benefits along with their tax provisions
- procedure for computation of net income under the head "Salaries".

5.1 INTRODUCTION

We have learnt till now that all incomes of an assessee are classified into 5 categories namely salaries, house property, capital gains, business or profession and other sources. An income covered under a particular category will be taxed under separate head of income pertaining to that category. Hence, it is very important to know which incomes are covered in each head and the detailed income tax provisions to calculate taxable income. In the previous lesson, we have learnt about the concept of salary income, its characteristics and three incomes forming part of salary, namely, basic salary, fees, commission, bonus and allowances. The present lesson describes in detail the other two components of salary income, namely, perquisites and retirement benefits along with the procedure of computation of income under this head.

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5.2 INCOMES FORMING PART OF SALARY-II

As already stated earlier, Section 17 broadly includes:

1. Basic salary
2. Fees, commission and bonus
3. Taxable value of cash allowances
4. Taxable value of perquisites
5. Retirement benefits

First three incomes are already explained in detail in the previous lesson. The other two incomes are explained here.

5.2.1 Taxable Value of Perquisites

Perquisites are defined as any casual emolument or benefit attached to an office or position in addition to salary or wages. It denotes some thing that benefits a man by going into his pocket; it does not cover mere reimbursement 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 employers 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 thereof
   (*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 ₹ 65,000.
4. Any sum paid by the employer towards any obligation of the employee.
5. Any sum payable by employer to effect an assurance on the life of assessee.
6. The value of any other fringe benefit given to the employee as may be prescribed.

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I. Classification of Perquisites

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 are taxable in case of specified employees only.
3. Perquisites that are exempt from tax for all employees.

1. **Perquisites Taxable in case of All Employees:** The following perquisites are taxable in case of every employee, whether specified or not:
   1. Rent free house provided by employer.
   2. House provided at concessional rate.
   3. Any obligation of employee discharged by employer *e.g.* payment of club or hotel bills of employee, salary to domestic servants engaged by employee, payment of school fees of employees' children etc.
   4. Any sum paid by employer in respect of insurance premia on the life of employee.
   5. Notified fringe benefits (on which fringe benefit tax is not applicable)–it includes interest free or concessional loans to employees, use of movable assets, transfer of moveable assets.
2. **Perquisites taxable in case of Specified Employees only:** The following perquisites are taxable in case of such employees:
   1. Free supply of gas, electricity or water supply for household consumption.
   2. Free or concessional educational facilities to the members of employees household.
   3. Free or concessional transport facilities.
   4. Sweeper, watchman, gardener and personal attendant.

Specified employee is an employee who is either a director or has substantial interest in the company where he is employed or is drawing monetary salary of more than ₹ 65,000 during the previous year.

   5. Any other benefit or amenity.
3. **Perquisites which are tax free for all the employees:** This category includes perquisites which are tax free for the employees and also other perquisites on which employer has to pay a tax (called Fringe Benefit Tax) if they are given to the employees and so are not taxable for them.
   1. Medical benefits (provided within or out of India) subject to limits.
   2. Value of Leave Travel Concession in India.
   3. Free meals provided to the employees during working hours.
   4. Amount spent by the employer as its contribution to staff welfare schemes.

5. Laptops and computers provided for personal use.
6. Rent free official accommodation provided to a Judge of High Court or Supreme Court or an official of Parliament including Minister and Leader of Opposition in Parliament.
7. Health Insurance Premium of employee or member of household paid by the employer.
8. All such facilities (like motor car, lunch refreshments, travelling, touring, gift, credit cards, club etc.) provided by employer on which employer has to pay Fringe Benefit Tax.

II. 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.

Member of household shall include:	
1. Spouse	2. Children and their spouses
3. Parents	4. Servants and dependents

(*i*) ***Valuation of rent free accommodation:*** For the purpose of valuation of house, employees are divided into 2 categories:

(*a*) *Central and State Government employees:* If accommodation is provided by the State or Central Government to their employees, the value of such accommodation is simply the amount fixed by the government (called the licence fees) in this regard.

(*b*) *Other Employees:*

Illustration 5.1

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 ₹ 3000 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:

(*a*) **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.

(*b*) **Other Employees:** The valuation of accommodation for this category of non-government employees depends upon whether the accommodation given to the employee is owned by the employer or taken on lease.

1. ***Accommodation owned by employer:*** The value of accommodation is:
   (*i*) 20% of salary in cities having population exceeding four lakhs as per 1991 census.
   (*ii*) 15% of salary in other cities in respect of the period for which the accommodation was occupied by the employee during the previous year.

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2. ***Accommodation is taken on lease/rent by the employer:*** The value of such accommodation is actual amount of lease rental paid or payable by the employer or 20% of salary, whichever is lower.

Definition of salary for rent free accommodation: Basic Salary + Taxable cash allowances + Bonus or Commission + any other monetary payment.

(It does not include dearness allowance if it is not forming part of basic salary for retirement benefit, allowances which are exempt from tax, value of perquisites specified under Section 17(2), employer's contribution to provident fund account of employees).

(*ii*) **Valuation of furnished accommodation** where the accommodation is furnished, 10% per annum of the original cost of furniture given to the employee shall be added to the value of unfurnished accommodation. If the furniture is taken on rent by employer, then actual hire charges are to be added to the value.

Rules for valuation of Rent free unfurnished Accommodation:

Nature of Accommodation	*Accommodation in a city with population > 4 lakhs*	*Accommodation in any other place*
Where accommodation is owned by employer	20% of salary	15% of salary
Accommodation taken on lease/rent by employer	Amount of lease or 20% of salary whichever is less	Amount of lease or 20% of salary whichever is less

Illustration 5.2

Mrs. X, a company employee gets ₹ 1,20,000 as basic pay, ₹ 24,000 as Commission, ₹ 10,000 as Bonus, ₹ 6000 as uniform allowance (60% utilized for uniform), ₹ 3,600 as education allowance and ₹ 12,000 as transport allowance. Her employer has paid income tax of ₹ 6,000 and professional tax of ₹ 2,000 on her behalf. A rent free unfurnished flat is provided in a place where population is:

(*a*) more than 4 lakhs or

(*b*) less than 4 lakhs. Determine the taxable value of rent free flat.

Solution:

Salary for this purpose:

Basic Salary	1,20,000
Commission	24,000
Bonus	10,000
Uniform allowance (40% of ₹ 6000)	2,400
Transport allowance (₹ 12000 Amount exempt ₹ 800 × 12)	2,400
Education allowance (₹ 3600 amount exempt ₹ 100 × 12 × 2)	1,200
Salary	**1,60,000**

(*a*) Where population is more than 4 lakhs
Value of rent free house = 20% of salary
= 20% of ₹ 1,60,000
= ₹ 32,000

(*b*) Where population is less than 4 lakhs
Value of rent free flat = 15% of salary
= 15% of ₹ 1,60,000
= ₹ 24,000

(*iii*) **Sweeper, gardener or watchman provided by the employer:** The value of benefit of provision of services of sweeper, watchman, gardener or personal attendant to the employee or any member of his household shall be the actual cost to the employer. The actual cost in such a case is 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.

If the above servants are engaged by the employer and facility of such servants are provided to the employees, it will be a perquisite for specified employees only. On the other hand, if these servants are employed by the employee and wages of such servants are paid/reimbursed by the employer, it will be taxable perquisite for all classes of employees.

(*iv*) **Free Supply of Gas, Electricity or Water:** The value of these benefits is taxable in the hands of specified employees, if the connection is taken in the name of the employer, and is determined according to the following rules:

(*a*) If the employer provides the supply of gas, electricity, and water from its own sources, the manufacturing cost per unit incurred by the employer shall be the value of perquisite.

(*b*) If the supply is from any other outside agency, the value of perquisite shall be the amount paid by the employer to the agency supplying these facilities.

(*c*) Where the employee is paying any amount in respect of such services, the amount so paid shall be deducted from the value of perquisite calculated under (*a*) or (*b*).

(*d*) Where the connection for gas, electricity, water supply is in the name of employee and the bills are paid or reimbursed by the employer, it is an obligation of the employee discharged by the employer. Such payment is taxable in case of all employees under Section 17 (2) (*iv*).

(*v*) **Free Education:**

(*a*) Cost of free education to any member of employees' family provided in an educational institution owned and maintained by the employer shall be determined with reference to reasonable cost of such education in a similar institution in a near by locality. For education facilities provided to the children of

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employee (excluding any other member of household), the value shall be nil, if the cost of such education per child does not exceed ₹ 1,000 per month.

(*b*) Where free education facilities are allowed to any member of employees' family in any other educational institution by reason of his being in employment of that employer, the value of perquisite shall be determined as in (*a*).

(*c*) In any other case: The value of benefit of providing free or concessional educational facilities for any member of the house hold (including children) of the employee shall be the amount of expenditure incurred by the employer.

(*d*) While calculating the amount of perquisite in all in above cases, any amount paid or recovered from the employee in this connection, shall be deducted.

(*vi*) **Free Transport:** The value of any benefit provided by any undertaking engaged in the carriage of passengers or goods to any employee or to any member of his household for private journey free of cost or at concessional rate in any conveyance owned or leased by it shall be taken to be the value at which such benefit is offered by such undertaking to the public as reduced by the amount, if any, paid by or recovered from the employee for such benefit. In case of employees of the Railways and airlines, the value of transport facility shall be exempt.

(*vii*) **Valuation of Medical Facilities:** Medical facilities provided to employee are exempt from tax.

A. Medical benefits within India which are exempt from tax include the following:

(*a*) Medical treatment provided to an employee or any member of his family in hospital maintained by the employer.

(*b*) Any sum paid by the employer in respect of any expenditure incurred by the employee on medical treatment of himself and members of his family :

(*i*) In a hospital maintained by government or local authority or approved by the government for medical treatment of its employees.

(*ii*) In respect of the prescribed diseases or ailments in any hospital approved by the Chief Commissioner.

(*iii*) Premium paid by the employer on health insurance of the employee under an approved scheme.

(*c*) Premium on insurance of health of an employee or his family members paid by employer.

Limited Exemption: If the ordinary medical treatment of the employee or any member of his family is done at any private hospital, nursing home or clinic, the exemption is restricted to ₹ 15,000.

B. Medical Treatment outside India which is exempt from tax includes the following:

(*a*) Any expenditure incurred by employer on the medical treatment of the employee or any member of his family outside India.

(*b*) Any expenditure incurred by employer on travel and stay abroad of the patient (employee or member of his family) and one attendant who accompanies the patient in connection with such treatment, shall be exempt to the following extent :

(*i*) The expenditure on medical treatment and stay abroad shall be exempt to the extent permitted by the Reserve Bank of India.

(*ii*) The expenditure on travel shall be exempt in full provided the gross total income of the employee (including this expenditure) does not exceed ₹ 2,00,000.

Illustration 5.3. (based on perquisites received by employee)

Mr. X is a Purchase Officer in a Company in Kota. He has furnished the following particulars of his incomes to you for the previous year 2008-09. You are required to compute his gross salary.

Salary @ ₹ 12,500 per month 1,50,000

Leave Travel Concession for proceeding on leave

(total expenditure on rail fare ₹ 4100) 3,800

Tiffen Allowance (actual expenditure ₹ 2700) 4,000

Reimbursement of medical expenses for treatment of X and his family in private clinic 31,300.

Besides, he enjoys the following perks:

- Free unfurnished flat at Delhi (rent paid by employer : ₹ 80,000)
- The employer provided two watchmen (salary ₹ 700 per month each).
- Free use of Maruti car for official use, car can be used for journey between office and residence and other private purposes (log book of car is not maintained).
- Free meal at place of works (₹ 70 per day for 210 days) ₹ 14,700.

Solution:

Computation of Income under the head salaries of Mr. X for AY 2006-07

Particulars	***Rupees***
Basic Salary	1,50,000
Leave Travel Concession (exempted from tax)	–
Tiffin Allowance (fully taxable)	4,000
Reimbursement of medical expenses (₹ 31,300 – ₹ 15,000)	16,300
Rent free unfurnished flat*	30,800
Two watchmen (₹ 700 × 2)	16,800
Free use of Maruti car	Nil
Free meals	Nil
Gross Salary	**2,17,900**

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* Salary for rent free unfurnished flat is 1,54,000 (1,50,000 + 4,000)

Value of rent free house is 20% of salary or rent paid by employer, whichever is lower (20% of 1,54,000 = 30,800)

5.2.2 Retirement Benefits

These benefits are provided by the employer to the employee for his future, either while in service or on his retirement. These have different tax treatment. They include:

(*a*) ***Pension:*** Pension is a payment made by the employer after the retirement or death of employee as a reward for past service. It is normally paid as a periodical payment on monthly basis but certain employers may allow an employee to forgo a portion of pension in lieu of lump sum amount. This is known as commutation of pension.

The treatment of these two kinds of pension is as under:

(*i*) *Periodical pension (or uncommuted pension).* It is fully taxable in the hands of all employee, whereas government or nongovernment.

(*ii*) *Commuted pension.* For employees of government organisations, local authorities and statutory corporations, it is fully exempted from tax, hence not included in gross salary.

For other employees, commuted value of half of the total value of pension is exempted from tax. Any amount received over and above this amount is taxable, so included in gross salary.

> *Pension received by employee is taxable under the head "Salaries". However, family pension received by legal heirs after death of employee is taxable under 'Income from other sources'.*

If, however, the employee is also receiving gratuity (another retirement benefit) along with pension, then one third of the total value of pension is exempted from tax. Amount received in excess of this is taxable, so included in gross salary.

(*b*) ***Gratuity:*** Gratuity is the payment made by the employer to an employee in appreciation of past services rendered by the employee. It is received by the employee on his retirement. Gratuity is exempted upto certain limit depending upon the category of employee. For the purpose of exemption, employees are divided into 3 categories:

(*i*) *Government employees and employees of local authority:* In case of such employees, the entire amount of gratuity received by then is exempted from tax. Nothing will be added to gross salary.

(*ii*) *Employees covered under Payment of Gratuity Act, 1972.* In case of employees who are covered under Payment of Gratuity Act, the minimum of the following amounts are exempted from tax:

- Amount of gratuity actually received
- 15 days of salary for every completed years of service or part thereof in excess of six months.

  (15/26 × [basic salary + Dearness Allowance] × No. of years of service + 1

  [if fraction > 6 months]).
- ₹ 3,50,000 (amount specified by government).

(*iii*) *Other employees.* In case of employees not falling in the above two categories, gratuity received from the employers is exempt to the extent of minimum of following amounts:

- *Actual amount of gratuity received.*
- Half month average salary for every completed year of service

  (1/2 × average salary of last 10 months × completed years of service).
- ₹ 3,50,000 (amount specified by government).

(c) ***Leave Salary:*** Employees are entitled to various types of leave. The leave generally can be taken (casual leave/medical leave) or it lapses. Earned leave is a kind of leave which an employee is said to have earned every year after working for some time. This leave can either be availed every year, or get encashment for it. If leave is not availed or encashed, it is allowed to be carried forward. This leave keeps getting accumulated and is encashed by employee on his retirement. The tax treatment of leave encashment is as under:

(*i*) Encashment of leave while in service. This is fully taxable and so is added to gross salary.

(*ii*) Encashment of leave on retirement. For the purpose of exemption of accumulated leave encashment, the employees are divided into two categories:

- *State or Central Government employees*

  Leave encashment received by government employees is fully exempted from tax. Nothing is to be included in gross salary.
- *Other employees*

  Leave encashment of accumulated leave at the time of retirement received by other employees is exempted to the extent of minimum of four amounts.

- Amount specified by Central Government (3,00,000).
- Leave encashment actually received.
- 10 months average salary (10 × average salary of 10 months preceeding retirement). Cash equivalent of unavailed leave.

(*Leave entitlement is calculated on the basis of maximum 30 days leave every year, cash equivalent is based on average salary of last 10 months*).

(d) ***Provident Fund:*** Provident Fund Scheme is a welfare scheme for the benefit of employees. Under this scheme, certain amount

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is deducted by the employer from the employee's salary as his contribution to Provident Fund every month. The employer also contributes certain percentage of the salary of the employee to the Fund. The contributions are invested outside in securities. The interest earned on it is also credited to the Provident Fund Account. At the time of retirement, the accumulated balance is given to the employee. Tax treatment of provident fund depends upon the type of provident fund being maintained by the employer. Employee's provident fund may be of the following three types:

(*i*) **Statutory Provident Fund:** This is set up under the provisions of Provident Fund Act, 1925 and is maintained by Government and Semi-Government organisations, local authorities, railways, universities and recognised educational institutions.

(*ii*) **Recognised Provident Fund:** This is set up under the Employee's Provident Fund and Miscellaneous Provisions Act, 1952 (PF Act, 1952) and is maintained by private sector employees. The establishments covered under PF Act, 1952 have two options; either to follow the same scheme at by the Government under the PF Act or draft their own scheme of PF but get recognition from Commissioner of Income Tax.

(*iii*) **Unrecognized Provident Fund:** If a provident fund is not recognized by the Commissioner of Income Tax, it is known as unrecognized PF. Besides these three funds, a person can also become a member of Public Provident Fund.

(*iv*) **Public Provident Fund:** The Central Government has established the Public Provident Fund for the benefits of general public to mobilize personal savings. Any member of general public (whether salaried or self employed) can participate in this fund by opening a Provident Fund Account at the State Bank of India or its subsidiaries or other nationalised banks. A salaried employee can simultaneously become member of employees provident fund (whether statutory, recognized or unrecognised) and public provident fund. Any amount may be deposited (subject to minimum of ₹ 500 and maximum of ₹ 70,000 per annum) under this account. The accumulated sum is repayable after 15 years. At present, it carries an interest rate of 8% per annum which is credited every year but payable only the time of maturity.

Tax treatment of these provident funds (*i.e.* the exemption and deduction available in respect of contributions to and payment from these funds) is summarised as follows:

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S. No.	*Particulars*	*Statutory PF*	*Recognised PF*	*Unrecognised PF*	*Public PF*
	Employees Contribution to PF	Exempted from tax	Exempted upto 12% of salary excess of employer's contribution in included in gross salary	Exempted from tax	Employer does not contribute
	Deduction under Section 80C on employee's contribution	Available	Available	Not Available	Available
	Interest credited to PF	Exempted from tax	Exemption upto notified rate (9.50%) per annum Excess of interest included in gross salary	Exempted from tax	Exempted from tax
	Lumpsum payment given to employee on retirement	Exempted from tax	Exempted from tax (if rendered continuous service of more than 5 years	Lumpsum includes: (*a*) Own Contribution-Exempt (*b*) Interest on own contribution-taxable as income from other sources (*c*) Employer's contsribution and interest thereontaxable so included in gross salary	Exempted from tax

- Salary here means basic salary + dearness allowance/dearness pay (if terms of employment provide) + commission (if fixed as percentage of turnover achieved by employee).

5.3 DEDUCTIONS FROM GROSS INCOME

The income chargeable under the head salaries is computed after making the following deductions under Section 16:

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1. Standard deduction [Section 16(i)] of the Act: From assessment year 2009-10, standard deduction has been withdrawn.
2. Entertainment Allowance [Section 16(ii)] of the Act as given earlier, entertainment allowance received from employer is first included in gross salary and thereafter, a deduction is allowed to government employees (State or Central Government) to the extent of least of following 3 amounts:
   (*i*) ₹ 5000
   (*ii*) 20% of basic salary
   (*iii*) Amount of Entertainment Allowance actually received during the year.
3. Professional Tax [Section 16(iii)] of the Act.

Professional tax or tax on employment levied by a State under Article 276 of the Constitution is allowed as a deduction only in the year when it is actually paid. If the professional tax is paid by the employer on behalf of the employee, it is first included in gross salary as a perquisite (since it is an obligation of employee fulfilled by employer) and then the same amount is allowed as deduction on account of professional tax from gross salary.

5.4 COMPUTATION OF INCOME FROM SALARIES

Computation of Net Salary of Mr. X
for the Assessment Year 2009–2010

Particulars	*Amount in Rupees*
Basic Salary	
Fees, Commission and Bonus	
Taxable value of cash allowances	
Taxable value of perquisites	
Retirement Benefits	
GROSS SALARY	
Less: Deductions from Gross Salary	
1. Standard Deduction	
2. Entertainment allowance deduction	
3. Professional tax deduction	
NET SALARY	

Illustration 5.4

Mr. X is a lecturer in a private college in Chennai. During the previous year 2005-06, he gets the following emoluments: Basic salary ₹ 10,000 per month, dearness allowance: 10% of basic salary, city compensatory allowance: ₹ 300 per month, children education allowance: ₹ 500 per month (for 3 children), house rent allowance: 20% of salary (rent paid ₹ 2000 per month). He gets ₹ 18,000.

(*a*) Reimbursement from his employer in respect of medical expenditure incurred on treatment of his wife in a private clinic. Besides, he gets ₹ 11,400 as reimbursement from the employer in respect of books and journals purchased by him in discharging his official work. He contributes 11% of his salary to statutory provident fund to which a matching contribution is made by the employer. During the year, he spends ₹ 15,000 for maintaining a car for going to the college. Determine his net income under the head salaries.

Computation of Net Salary of Mr. X for the Assessment Year 2009–10

Particulars	*Amount*
Basic Salary (₹ 10,000 × 12)	1,20,000
Dearness allowance (10% of 1,20,000)	12,000
City compensatory allowance (₹ 300 × 12)	3,600
Children education allowance (₹ 500 × 12 less amount exempt ₹ 100 × 12 × 2)	3,600
House Rent Allowance (20% of 1,20,000 less amount exempt ₹ 12,000)	12,000
Reimbursement of medical expenses (*₹ 18,000 – ₹ 15,000*)	3,000
Reimbursement of expenses on books not chargeable to tax	—
GROSS SALARY	1,54,200
Less Standard deduction	NIL
NET SALARY	1,54,200

Working Notes:

1. Amount of HRA exempt is least of 3 figures:
   (*a*) 50% of Salary (1,20,000) 60,000
   (*b*) Actual HRA received (20% of 1,20,000) 24,000
   (*c*) *Rent paid in excess of 10% of Salary*
   2000 × 12 – 10/100 × 1,20,000 12,000
   Amount of HRA exempt is 12,000
2. Expenditure on maintenance of car is an application of income, not deductible.
3. Contribution of employer towards employee's statutory provident fund is exempt upto 12%.
4. Reimbursement of *medical expenditure* by *employer in private* clinic is exempt upto ₹ 15,000.
5. Children education allowance is exempt to the extent of ₹ *100* per month per child for maximum 2 children.

SUMMARY

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1. Heads of Income: There are 5 heads of income into which income of persons can be divided namely Income from salary, house property, business or profession, capital gains and other sources.
2. Meaning of Salary: Any remuneration paid by an employer to an employee in consideration of his services is called salaries. It includes monetary value of those benefits and facilities which are provided by the employer and are taxable.
3. Income forming part of salary: They include basic salary, advance salary, fees, commission, and bonus, taxable value of cash allowances, perquisites and retirement benefits.
4. Allowances: These are of three types
   (*a*) Taxable Allowances: Dearness allowance, Medical allowance, Servant allowance, Warden Allowance, Family allowance, City Compensatory allowance etc.
   (*b*) Allowances exempt upto specified limit: House rent allowances, Entertainment allowance, Certain Special allowances, etc.
   (*c*) Fully exempted allowances: Foreign allowance, sumptuary allowance to High Court / Supreme Court Judges, Allowances from U.NO.
5. Perquisites: These are of three types:
   (*a*) Taxable perquisites for all employees: Facility of rent-free house or house at concessional rent, payment of employee's obligations, payment of life insurance premium of the employee, etc.
   (*b*) Perquisites taxable in specified cases only: Facility of servant, gardener, gas, electricity, water, education, etc.
   (*c*) Tax-free perquisites: Free Medical facility or reimbursement of medical expenses, free facility of refreshments, entertainment, telephone, family planning, scholarship, leave travel concession, free motor car, club facility, gifts etc.
6. Valuation of perquisites: See Rule 3 of Income Tax Rules.
7. Deductions: Following three deductions are admissible:
   (*a*) Standard Deduction: This has been withdrawn from Assessment Year 2009-10.
   (*b*) Entertainment Allowance:
      (*i*) Government employees–1/5th of salary or ₹ 5,000, whichever is less.
      (*ii*) Others–Nil
   (*c*) Employment Tax–Full Amount
8. Provident Funds: These are of four types:
   (*a*) Statutory provident fund
   (*b*) Recognized provident fund
   (*c*) Unrecognized provident fund and
   (*d*) Public provident fund

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REVIEW QUESTIONS

1. Mrs. X (Age: 29 years) is a part-time lecturer in Delhi University. The details of her salary income are as follows:

	₹
Basic Salary	60,000
Dearness Allowance	2,400
Education Allowance for 2 children	3,600
Hostel expenditure allowance for one child	6,080
House Rent Allowance	
(Rent paid by Mrs. X is ₹ 900 per month)	8,000

She is a member of statutory Provident Fund to which she contributes 12% of her salary and similar amount is contributed by the College. Besides, College reimburses ₹ 21,600 being expenditure incurred by Mrs. X on medical treatment of her daughter in a private clinic. She spent ₹ 700 on purchase of books for teaching purpose. She has maintained a scooter for commuting to College and spends ₹ 500 per month on it. Compute net salary of Mrs. X for assessment year 2009-10.

Hints: 1. Medical expenditure incurred in private hospital is exempt upto ₹ 15,000
2. HRA taxable is ₹ 4,400
3. *No deduction is given for expenses* incurred in earning salary income

2. Mr. X receives the following incomes during the year ending on 31st March, 2009

	₹
Salary @ ₹ 12,500 per month	1,50,000
Leave Travel Concession for proceeding	
on Leave (actual expenditure ₹ 4,100)	3,800
Tiffin allowance (actual expenditure ₹ 2,700)	4,000
Reimbursement of medical expenses of X and	
his family in private clinic	31,300

Besides, X enjoys *the following perks:*

Free unfurnished flat in Delhi (rent paid by the employer ₹ 80,000) The employer provides a watchman and a gardener/salary paid to both @₹ 7,000 per month)

Free use of Maruti Car for private and official purposes. Expenditure incurred by employer ₹ 30,000

Free meal at place of work: ₹ 14,700 paid directly to the canteen by employer.

Determine the income under the head salaries.

Hints: 1. Leave Travel Concession is fully exempt from tax.
2. Tiffin allowance is fully taxable
3. Value of rent free flat is calculated as 20% of salary or lease *rent paid by employer, whichever is less.* [Value of flat: ₹ 30,800].
4. Free Car and free meals are taxable in the hands of employer as fringe benefits undrr fringe benefit tax and so are not *taxable for employees who receive them.*

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3. Mr. X, an employee of A Ltd. receives the following salary and perquisites from his employer during the previous year 2008-09.

Basic salary ₹ 96,000, Bonus ₹ 4,500, Commission on Sales @ 2 percent of turnover (turnover of the year 2005-06 achieved by X ₹ 4,50,000), advance salary of April, May and June 2009 received in March 2009 ₹ 24,000, employer's contribution to recognized provident fund ₹ 13,220, interest credited to the provident fund account @ 14.5 per cent ₹ 8,700, rent free furnished house in Calcutta (lease rent of ₹ 78,550 paid by employer, rent of furniture ₹ 23,500). Free services of gardener (salary paid ₹ 6,000); watchman (salary ₹ 7,200) and cook (salary ₹ 7000) were provided by the employer.

Determine taxable income of X for the Assessment year 2009–10.

Hints: 1. Advance salary is taxable on receipt basis, so is included in salary.
2. Employers' contribution to recognized provident fund is exempt to the extent of 12% of basic salary + commission– ₹ 620.
3. Interest credited to the extent of 9.5 per cent is exempt, balance is taxable– ₹ 3000.
4. Salary of watchman, gardener and cook is fully taxable.
5. Value of rent free house– ₹ 21,900.

FURTHER READINGS

- Singhania V.K. and Monica Singhania (2006), *Students Guide to Income Tax*, Taxmann Publications, Pvt. Ltd., New Delhi (latest edition).
- Chandra Mahesh and D.C. Shukla (2006), *Income Tax Law Practice*, Pragati Publication, New Delhi.
- Mehrotra H.C. (2006), *Income Tax Law and Accounts*, Sahitya Bhawan, Agra.
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CHAPTER

6

INCOME FROM HOUSE PROPERTY

STRUCTURE

6.0 LEARNING OBJECTIVES

After going through this lesson, you should be able to understand:

- the meaning of house property
- who is treated as owner of house property
- the treatment of rental income from properties under different circumstances
- determination of the annual value of a house property
- the expenses deductible from rental/notional income from house property
- special treatment given to self-occupied house property
- treatment of income/loss from house property.

6.1 INTRODUCTION

This lesson deals with income, which falls under the head 'Income from house property'. The scope of income charged under this head is defined by Section 22 of the Income Tax Act and the computation of income falling under this head is governed by Sections 23 to 27. All the provisions relating to tax treatment of income from house property are explained in this lesson.

6.2 BASIS OF CHARGE (SECTION 22)

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, 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.

6.2.1 Applicability of Section 22

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 car-parking 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, cooperative 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. Income from subletting is not taxable under Section 22. For 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 association, 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.

6.2.2 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 value 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.

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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 'Income 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 Income-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.

Property Incomes Exempt from Tax

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)].

NOTES

6.3 COMPUTATION OF INCOME FROM LET OUT HOUSE PROPERTY

Income from house property is determined as under:

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

6.3.1 Determination of Annual Value

The basis of calculating Income from House property is the 'annual value'. This is the inherent capacity of the property to earn income 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).
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 payeris 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 neighborhood, 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. 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:

(*a*) The tenancy is bona fide;

(*b*) The defaulting tenant has vacated, or steps have been taken to compel him to vacate the property;

(*c*) The defaulting tenant is not in occupation of any other property of the assessee;

(*d*) 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.

Illustration 6.1

Find the Gross Annual Value in the case of the following properties:

	1	*2*	*3*	*4*	*5*
Municipal value	52,000	1,00,000	1,60,000	75,000	1,80,000
Fair rent	60,000	102,000	68,000	70,000	1,85,000
Standard rent	N.A.	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

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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 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.

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).

6.3.2 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

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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/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/ 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 preceeding the date of acquisition or completion of construction, whichever is earlier, is termed as the pre-construction period. The interest paid/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. This deduction is not allowed if the loan is utilized for repairs, renewal or reconstruction.

Illustration 6.2

X takes a loan of ₹ 10,00,000 @ 12% p.a. on July 1, 2001 for the construction of a house property. The construction of the property is completed on January 15, 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 preceeding 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.

6.4 COMPUTATION OF INCOME FROM SELF-OCCUPIED HOUSE PROPERTY

NOTES

The annual value of one self-occupied house property, which has not been actually let out at anytime 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 selfoccupation, 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 subject 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 there from.
- 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 unit(s) 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 up to 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 Section 23(2) (a) is not available and the income from the property will be calculated as if it is let out.

6.5 SOME SPECIAL PROVISIONS

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 theworkplace, 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 upto 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.

SUMMARY

Under Section 22 of the Income Tax Act, the annual value of house property, consisting of buildings and lands appurtenant thereto, is taxable under the head 'Income from house property', in the hands of the owner (or deemed owner) of the property, provided that the property is not used by the assessee for the purpose of his own business or profession.

For determining the annual value of the house property, the actual rent received or receivable from the property, the municipal valuation, the fair rental value and the standard rent under the Rent Control Act are taken into account.

From the Gross Annual Value of the property, the Municipal Taxes are deducted to arrive at the Net Annual Value. Section 24 of the Income Tax Act provides that 30% of the NAV and the interest on borrowed capital shall be deducted from the NAV to obtain the taxable income from house property.

As per Section 23(2) of the Income Tax Act, the annual value of one selfoccupied house property is taken to be nil. No deductions are permissible from the annual value of such property, except the interest on borrowed capital, subject to the maximum limit of ₹ 1,50,000 or ₹ 30,000 as the case may be.

The above provisions may result in loss from house property, which may be set off against income from another house property or against incomes under the other heads. The balance loss may be carried forward, to be set off against the income from house property, upto a maximum of eight assessment years.

REVIEW QUESTIONS

1. What is 'annual value'? How is the annual value of a let out house-property determined?
2. How will you arrive at the annual value of a house property which is partly let out and partly self-occupied during the previous year?
3. Explain the provisions of the Income Tax Act with respect to the computation of income from a self-occupied house property.
4. What deductions are allowed from the annual value in computing the taxable income from house property?
5. Explain the tax treatment of unrealized rent.
6. 'It is only the owner of the house property who is chargeable to tax on income from house property'. Explain.
7. Compute taxable income from house property from the following particulars:

Fair market rent	₹ 80,000
Actual rent	₹ 72,000
Municipal valuation	₹ 50,000
Standard rent	₹ 60,000
Municipal Taxes	20%
Interest paid	₹ 18,000

8. X owns a house whose Municipal valuation is ₹ 30,000 and the fair rent is ₹ 43,200 per annum. During the previous year, the house is let out for residential purposes w.e.f. 1st April, 2008 to 30th June, 2008 at the rate of ₹ 4,000 per month and self-occupied for residential purposes for the remaining part of the year. He incurred the following expenses in respect of this house:

   Municipal taxes ₹ 6,000, Ground rent ₹ 5,000 and Fire Insurance Premium ₹ 1,000. A loan of ₹ 50,000 was taken on 1st April, 2000 at the rate of 10% per annum for the construction of the house which was completed on 1st January, 2003. No part of the loan has been repaid so far. Compute his income from house property for the Assessment year 2009-2010.

FURTHER READINGS

- Dinker Pagare; *Law and Practice of Income Tax*; Sultan Chand & Sons; latest edition.
- Girish Ahuja and Ravi Gupta; *An Elementary Approach to Income Tax & Sales Tax;* Bharat Publications; latest edition.
- H.C. Mehrotra; *Income-tax Law and Accounts;* Sahitya Bhawan; latest edition.
- Mahesh Chandra & D.C. Shukla; *Income-tax Law and Practice;* Pragati Publications; latest edition.
- Singhania V.K. and Monica Singhania; *Students' Guide to Income Tax;* Taxmann Publications Pvt. Ltd. (latest edition).

NOTES

UNIT

7

INCOME FROM BUSINESS AND PROFESSION

STRUCTURE

7.0 LEARNING OBJECTIVES

After going through this lesson, you should be able to understand:

- calculation of taxable profit and gains
- calculation of depreciation

- various specific deductions allowed
- various general deductions allowed
- presumptive taxation provisions.

NOTES

7.1 INTRODUCTION

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.

7.2 BASIS OF CHARGE

Under Section 28, the following income is chargeable to tax under the head "Profits and gains of business or profession":

(*a*) profits and gains of any business or profession;

(*b*) any compensation or other payments due to or received by any person specified in Section 28(ii);

(*c*) income derived by a trade, professional or similar association from specific services performed for its members;

(*d*) the value of any benefit or perquisite, whether convertible into money or not,arising from business or the exercise of a profession;

(*e*) export incentive available to exporters;

(*f*) any interest, salary, bonus, commission or remuneration received by a partner from firm;

(*g*) 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.;

(*h*) any sum received under a Key man insurance policy including bonus;

(*i*) profits and gains of managing agency; and

(*j*) income from speculative transaction. Income from the aforesaid activities is computed in accordance with the provisions laid down in Sections 29 to 44D.

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7.3 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.

- There are two main methods of accounting—mercantile system and cash system.
- 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.
- 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).

7.4 SCHEME OF BUSINESS DEDUCTIONS

Section 28 defines various income which are chargeable to tax under the head "Profits and gains of business or profession". Section 29 permits deductions and allowances laid down by Sections 30 to 43D while computing profits or gains of a business or profession.

7.5 SPECIFIC DEDUCTIONS UNDER THE 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:

7.5.1. 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:

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(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 hasoccupied 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. Application of Section 43B-Land revenue, local rates or municipal taxes are deductible subject to the conditions as specified by Section 43B.

7.5.2. 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.

7.5.3. 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:

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.

Asset Should be Owned by the Assessee—The asset should be owned by the assessee or the assessee should be the co-owner of the asset.

Asset Must be 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 or profession.

User of the Asset in the Previous Year—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 sometime 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.

Depreciation is Available on Tangible as well as Intangible Assets—Under the Income-tax Act, one can claim depreciation in respect of the following assets—

Tangible assets	Building, machinery, plant or furniture
Intangible assets acquired after March 31, 1998	Know-how, patents, copyrights, trade marks, licenses, franchises or any other business or commercial rights of similar nature.

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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 equipments 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, trade marks, 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 the assessment year 2009-10 will be determined as under:

STEP-1	Find out the depreciated value of the block on the April 1, 2005.
STEP-2	To this value, add "actual cost" of the asset (falling in the block) acquired during the previous year 2008-09.
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 2008-09.

- Other points–The following points should be noted—

1. The resulting amount is the written down value of the block of assets on March 31, 2009 relevant for the assessment year 2009–10.
2. The amount of reduction under Step 3 cannot exceed the value of assets computed under Step 1 and Step 2.
3. One may determine written down value for other assessment years on similar basis.
4. In some cases, computation of written down value is based upon notional figures [see problem 91-P6].
5. 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.

ILLUSTRATION

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7.5.4 Exceptions to the Rule

In the cases given below, the above-mentioned rule is not applicable:

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.

When the written down value of a block of asset is reduced to zero– No depreciation is admissible where written down value has been reduced to zero, though the block of assets does not cease to exist on the last day of the previous year.

Illustration 7.1

Provision illustrated. On April 1, 2009, depreciated value of a block of asset (rate of depreciation : 15 per cent) is ₹ 80,000. It consists of Plants A and B. The assessee purchases Plant C (rate of depreciation : 15 per cent) on December 28, 2009 for ₹ 30,000 and sells Plant A on May 3, 2009 for ₹ 1,80,000. In this case on March 31, 2010, the assessee has Plant B and Plant C in the block of the asset, though the written down value of the block is zero. No depreciation will be admissible for the previous year 2009-10 (*i.e.*, the assessment year 2010-11) as is evident from the computations given below:

Solution:

	₹
Depreciated value of the block consisting of plants A and B	80,000
Add: Actual cost of plant C	30,000
Total	1,10,000
Less : Sale consideration of plant A [though the plant is sold for ₹ 1,80,000, the amount of reduction cannot exceed ₹ 1,10,000; the difference of ₹ 70,000 is short-term capital gain under Section 50(1)]	1,10,000
Written down value of the block consisting of plants B and C	Nil
Less : Depreciation for the previous year 2009-10	Nil
Depreciated value of the block consisting of plants B and C on April 1, 2010	Nil

7.5.5 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:

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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)	1. Contribution to an approved scientific research association. under Section 35(1)(*ii*)/(*iii*)
3. Expenditure on an approved in-house research under Section 35(2AB)	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.

Provisions illustrated - 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)/(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—

(*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*)/(*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. 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.

7.5.6 Amortisation of Preliminary Expenses

Certain preliminary expenses are deductible under Section 35D.

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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—

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

Note—*Deduction under Seetion 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 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, under writing 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—

In the case of a corporate assessee	*In the case of a non-corporate assessee*
(*a*) 5 per cent of cost of project; or (*b*) 5 per cent of capital employed, whichever is more	5 per cent of cost of project

Cost of project—It 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.

7.5.7 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.

7.5.8 Interest on Borrowed Capital

Interest on capital borrowed is allowed as deduction if the following conditions are satisfied—

Condition one	The assessee must have borrowed money.
Condition two	The money so borrowed must have been used for the purpose of business.
Condition three	Interest is paid or payable on such borrowing.

7.6 GENERAL DEDUCTION

Section 37(1) is a residuary Section. In order to claim deduction under this Section, the following conditions should be satisfied—

Condition one	The expenditure should not be of the nature described under Sections 30 to 36.
Condition two	It should not be in the nature of capital expenditure.
Condition three	It should not be personal expenditure of the assessee.
Condition four	It should have been incurred in the previous year.
Condition five	It should be in respect of business carried on by the assessee.
Condition six	It should have been expended wholly and exclusively for the purpose of such business.
Condition seven	It should not have been incurred for any purpose, which is an offence or is prohibited by any law.

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7.7 SPECIFIC DISALLOWANCE

The following expenses given by Sections 40, 40A and 43B are expressly disallowed by the Act while computing income chargeable under the head "Profits and gains of business or profession".

7.7.1 Amount not Deductible Under Section 40(*a*)

In the case of any assessee, the following expenses are expressly disallowed under Section 40(*a*)—

INTEREST, ROYALTY, FEES FOR TECHNICAL SERVICES PAYABLE TO A NON-RESIDENT [SEC. 40(*a*) (*i*)]—Disallowance under Section 40(*a*) (*i*) is attracted if the following conditions are satisfied—

Condition one	The amount paid is interest (not being interest on any loan issued for public subscription before April 1, 1938), royalty, fees for technical services or other sum.
Condition two	The aforesaid amount is chargeable to tax under the Act in the hands of the recipient
Condition three	The aforesaid amount is paid/payable as follows— *Situation paid/payable* — *Place of payment* — *To whom it is* Situation 1 — Outside India — To a resident or non-resident Situation 2 — In India — To a non-resident or foreign company
Condition four	In respect of the aforesaid, tax is deductible but tax has not been deducted; or tax has been deducted but after deduction it has not been paid to the Government in the previous year [or in a subsequent year before the expiry of time given under Section 200(1)]

CONSEQUENCES IF THE ABOVE CONDITIONS ARE SATISFIED—If the above conditions are satisfied, the aforesaid expenditure is not deductible.

CONSEQUENCES IF TAX IS DEDUCTED SUBSEQUENTLY—If tax is deducted/paid subsequently, then deduction is available in some cases.

COMPLIANCE OF TDS PROVISIONS IN CASE OF A RESIDENT [SEC. 40(a) (ia)]—

Section 40(a) (ia) is applicable from the assessment year 2005-06 if the following conditions are satisfied—

1. It covers interest, commission or brokerage, fees for technical services, fees for professional services and payment to contractors/ sub-contractors.

2. In the above cases recipient is resident in India.
3. In respect of the aforesaid—
   (*a*) tax is deductible but tax has not been deducted; or
   (*b*) tax has been deducted but after deduction it has not been paid to the Government in the previous year [or in a subsequent year before the expiry of time given under Section 200(1)].

CONSEQUENCES IF THE ABOVE CONDITIONS ARE SATISFIED—If the above conditions are satisfied, the aforesaid expenditure is not deductible with effect from assessment year 2005-06.

CONSEQUENCES IF TAX IS DEDUCTED SUBSEQUENTLY—If tax is deducted/paid subsequently, then deduction is available in some cases. The same is explained in the table given below—

Different situations	*Deductible in which year*
If in respect of expenses mentioned above, (*a*) tax has been deducted under the relevant Sections, and (*b*) paid to the Government in the same year and before the expiry of timelimit given under Section 200(1)	Deductible in the year in which the liability to pay interest, commission, brokerage, etc., is incurred
If in respect of expenses mentioned above, (*a*) tax has been deducted under the relevant Sections, and (*b*) paid to the Government in the same financial year but after the expiry of time-limit given under *Section 200(1)*	Deductible in the year in which the liability to pay interest, commission, etc., is incurred
If in respect of expenses mentioned above, (*a*) tax has been deducted under the relevant Sections, and (*b*) paid to the Government in the subsequent year but before the expiry of time limit given in Section 200(1)	Deductible in the year in which the liability to pay interest, commission, brokerage, etc., is incurred
If in respect of expenses mentioned above, (*a*) tax has been deducted under the relevant Sections, and (*b*) paid to the Government in a subsequent year [but after the expiry of time limit given in Section 200(1)]	Deductible in the year in which tax has been paid
If in respect of expenses mentioned above, (*a*) tax has not been deducted, or (*b*) tax has been deducted but not paid to the Government	Not deductible

Illustration 7.2

XY, a partnership firm, commenced production on December 1, 2009. The firm has made the following expenditure on scientific research up to the year ending on March 31, 2010—

1. On December 13, 2009 the firm pays ₹ 90,000 to the Indian Agricultural Research Institute, New Delhi, being an approved scientific research

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institution under Section 35(1)(*ii*), for the purpose of carrying out scientific research in natural science.

2. On December 21, 2009 the firm pays ₹ 60,000 to the Indian Institute of Management, Ahmedabad, being an approved institute under Section 35(1)(*iii*), for the purpose of carrying out scientific research in social or statistical science.
3. On January 10, 2010, the firm pays ₹ 40,000 to an approved National Laboratory for carrying out programmes of scientific research.
4. On December 23, 2009, the firm purchases a plot of land for ₹ 2,00,000. Later on a laboratory building is constructed (cost of construction : ₹ 1,70,000 date of completion of construction : March 1, 2010) to start in-house research.
5. Before the commencement of the production, the firm had made the following revenue expenditure for its research laboratory—
   - Expenditure on salary and perquisite to research personnel and research material during the 12 months ending on November 30, 2006 : ₹ 20,000.
   - Expenditure on salary of research personnel from December 1, 2006 to November 30, 2009 : ₹ 61,000 (out of which amount certified by the prescribed authority is ₹ 42,000).
   - Expenditure on providing rent-free flats and club facility to research personnel, from December 1, 2006 to November 30, 2009; ₹ 8000.
   - Expenditure on research material from December 1, 2006 to November 30, 2009 : ₹ 46,800 (out of which amount certified by the prescribed authority is ₹ 34,800).
   - Capital expenditure on scientific research (not certified by the prescribed authority)—

	Expenditure incurred up to November 30, 2006 ₹	*Expenditure incurred between December 1, 2006 and November 30, 2009* ₹
Purchase of land for growing herbals for research	50,000	60,000
Purchase of equipments for research	30,000	40,000
Expenditure of capital nature for cultivation of herbals	2,000	4,600

Determine the amount of deduction available XY under Section 35(1) for the assessment year 2010-2011, if the scientific research is (*a*) related or (*b*) unrelated to the business of the assessee-firm.

Solution: The amount of deduction under Section 35 for the assessment year 2010-11 will be determined as follows—

	Where the scientific research is	
	related to the business ₹	unrelated to the business ₹
1. Payment of ₹ 90,000 to an approved scientific research institution for carrying on research in natural science is qualified for a weighted deduction under Section 35(1)(*ii*) even if the research is not related to the business of assessee [*i.e.*, ₹ 90,000 × 1.25]	1,12,500	1,12,500
2. Payment of ₹ 60,000 to an approved institution for carrying on scientific research in social science is qualified for a weighted deduction under Section 35(1)(*iii*) even if the scientific research is not related to the business of assessee [*i.e.*, ₹ 60,000 × 1.25]	75,000	75,000
3. Payment of ₹ 40,000 to approved National Laboratory is qualified for weighted deduction (even if scientific research is not related to the business of assessee) [*i.e.*, ₹ 40,000 × 1.25]	50,000	50,000
4. Cost of laboratory building (excluding cost of land)	1,70,000	—
5. Expenditure on salary (excluding perquisite) to research personnel and expenditure on material for scientific research incurred within 3 years before commencement of business is deductible under Section 35(1)(*i*) if the research is related to the business of the assessee—		
• ₹ 20,000 being expenditure on salary and perquisites is not deductible as it is not incurred within 3 years before commencement of business	Nil	Nil
• ₹ 42,000 being expenditure on salary to research personnel as certified by the prescribed authority within 3 years before commencement of business is deductible if research is related to the business of assessee	42,000	Nil
• ₹ 8,000 being expenditure on providing perquisites to research personnel before commencement of business is not deductible even if research is related to the assessee's business	Nil	Nil
• ₹ 34,800 being expenditure as certified by the prescribed authority on purchasing research material within 3 years before	34,800	Nil

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commencement of business is deductible if research is related to the assessee's business		
• Cost of land purchased for growing herbals (not deductible)	—	—
• ₹ 40,000 (being the cost of equipment) is deductible if research is related to the business.	40,000	—
• ₹ 4,600 being cost of growing herbals is deductible if research is related to the business	4,600	—
Amount deductible under Section 35 for the assessment year 2010-11	5,28,900	2,37,500

Illustration 7.3

XYZ Ltd., a paper manufacturing concern, purchases a machine on March 1, 1997 for ₹ 6,10,000 for its laboratory with a view to improving the quality of art paper manufactured by the company.

1. What will be the amount of deduction under Section 35 on account of capital expenditure of ₹ 6,10,000 for the assessment year 1997-98.
2. If the research activity for which the aforesaid machine is purchased ceases in 2008 and the machinery is brought into business proper on November 1, 2008 (market value of the machine: ₹ 2,30,000) ; depreciation is admissible at the rate of 15 per cent; depreciated value of the relevant block of assets on April 1, 2008 is ₹ 14,07,860, the scientific research machine is sold for ₹ 1,90,000 on April 4, 2009, what will be the amount of depreciation and amount of chargeable profit under Section 41(3).
3. If the research activity for which the machine was purchased ceases on November 1, 2008 (market value of the machine ; ₹ 2,30,000) and the machine is sold on April 4, 2009 without using it for another purpose, sale price being ₹ 1,90,000 or ₹ 5,40,000 or ₹ 8,10,000 or ₹ 15,00,000.

Solution:

1. As the scientific research is related to the business of assessee, the whole of capital expenditure of ₹ 6,10,000 is allowable as deduction under Section 35(2)(*ia*) for the assessment year 1997-98.
2. The machine is brought into business proper on November 1, 2008. Profit arising on sale of machinery is, in this case, not chargeable under sub-Section (3) of Section 41. Provision of sub-Section (3) of Section 41 would not apply as the Section covers only such assets which are represented by expenditure of capital nature on scientific research that is sold without having been used for any other purpose.

Tax treatment of depreciation will be as under:

	₹
Depreciated value of the block of assets on April 1, 2008	14,07,860
Add : Cost of machine transferred from laboratory on November 1, 2008 [*i.e.*, ₹ 6,10,000—deduction of ₹ 6,10,000 claimed under Section 35—see para 109.10-2]	Nil
Written down value	14,07,860
Less : Depreciation for the previous year 2008-2009 [15% of ₹ 14,07,860]	2,11,179
Depreciated value of the block on April 1, 2009	11,96,681
Less : Sale proceeds of machine sold on April 4, 2009	1,90,000
Written down value	10,06,681
Less : Depreciation for the previous year 2009-10 [15% of ₹ 10,06,681]	1,51,002
Depreciated value of the block on April 1, 2010	8,55,679

There will be no capital gain or loss in this case.

3. Tax treatment should be as under :

	If sale price is			
	₹ *1.90 lakh* ₹	₹ *5.40 lakh* ₹	₹ *8.10 lakh* ₹	₹ *15 lakh* ₹
Amount chargeable under Section 41(3) (*i.e.*, sale proceeds but subject to maximum of deduction claimed under Section 35 for the assessment year 1997-98)	1,90,000	5,40,000	6,10,000	6,10,000
Capital gain under Section 45				
Sale proceeds	1,90,000	5,40,000	8,10,000	15,00,000
Less : Indexed cost of acquisition [*i.e.*, ₹ 6,10,000 × 632/305 - see para 175.2-2	12,64,000	12,64,000	12,64,000	12,64,000
Long-term capital gain or loss	(–)10,74,000	(–)7,24,000	(–)4,54,000	2,36,000

Note—It can be seen from the above computation that when the capital asset is transferred for ₹ 1.90 lakh without putting it to some other use, the taxpayer can claim long-term capital loss of ₹ 10,74,000 apart from claiming deduction under Section 35–*Pharmson Pharmaceuticals Ltd. v. CIT[2003] 87 ITD 668(Delhi)**. To avoid double deduction, it is suggested to the Government that a suitable amendment should be made in Section 35 incorporating the following—

"Where deduction is allowed in respect of a capital expenditure under Section 35(1)(*iv*), no deduction shall be allowed in respect of the said expenditure under any other provision of the Act in any year".

*Contray ruling is given by the Mumbai Tribunal in the case of ***Maharashtra Hybrid Seeds Co. Ltd.*** v. ***CIT*** (2005)24 SOT 475.

SECURITIES TRANSACTION TAX [SEC. 40(a) (ib)]—

Securities transaction tax is not deductible while calculating business income.

NOTES

FRINGE BENEFIT TAX [SEC. 40(a) (ic)]—Fringe benefit tax is not deductible while calculating business income from the assessment year 2006-07.

INCOME-TAX [SEC. 40(a) (ii)]—Any sum paid on account of income-tax (i.e., any rate or tax levied on the profits or gains of any business or profession) is not deductible. Similarly, any interest/penalty/fine for non-payment or late payment of income-tax is not deductible. This rule is applicable whether income-tax is payable in India or outside India.

WEALTH-TAX [SEC. 40(a)(iia)]—Any sum paid on account of wealth-tax under the Wealth-tax Act, 1957, or tax of a similar nature chargeable under any law outside India is not deductible.

SALARY PAYABLE OUTSIDE INDIA WITHOUT TAX DEDUCTION [SEC. 40(a) (iii)]–Section 40(*a*) (*iii*) is applicable if the following conditions are satisfied—

Condition one	The payment is chargeable under the head "Salaries" in the hands of the recipient.
Condition two	It is payable— (*a*) outside India (to any person resident or non-resident); or (*b*) in India to a non-resident.
Condition three	Tax has not been paid to the Government nor deducted at source under the Income-tax Act.

If the aforesaid conditions are satisfied, then the payment is not allowed as deduction.

PROVIDENT FUND PAYMENT WITHOUT TAX DEDUCTION AT SOURCE [SEC. 40(a) (iv)]—Any payment to a provident fund (or other fund established for the benefit of employees of the assessee) is not deductible if the assessee has not made effective arrangements to secure that tax shall be deducted at source from any payments made from the fund which are chargeable to tax under the head "Salaries".

TAX ON PERQUISITE PAID BY THE EMPLOYER [SEC. 40(a) (v)]—

The provisions of Section 40(a) (v) are given below—

1. The employer provides non-monetary perquisites to employees.
2. Tax on non-monetary perquisites is paid by the employer.
3. The tax so paid by the employer is not taxable in the hands of employees by virtue of Section 10(10CC).
4. While calculating income of the employer, the tax paid by the employer on non-monetary perquisites is not deductible under Section 40(a) (*v*).

7.7.2. Amount not Deductible Under Section 40A(2)

Any expenditure incurred by an assessee in respect of which payment has been made to the specified persons is liable to be disallowed in computing business profit to the extent such expenditure is considered to be excessive or unreasonable, having regard to the fair market value of goods or services or facilities, etc.

As per Section 2(41), the term relative in relation to an individual means husband, wife, brother or sister or any lineal ascendant or descendant of that individual.

7.7.3 Amount not Deductible Under Section 40A(3)

The provisions of Section 40A (3) are given below-RULE—The following conditions should be satisfied—

Condition one	The assessee incurs any expenditure, which is otherwise deductible under the other provisions of the Act for computing business/profession income (e.g., expenditure for purchase of raw material, trading goods, expenditure on salary, etc.). The amount of expenditure exceeds ₹ 20,000.
Condition two	A payment in respect of the above expenditure (or part there of) exceeds ₹ 20,000.
Condition three	The payment mentioned in condition two is made in cash or by bearer cheque (*i.e.*, not by crossed cheque or crossed demand draft).

If all the above conditions are satisfied, then 20 per cent of such payment is not allowable as deduction. However, there are certain exceptions to the above rule.

7.8 AMOUNT NOT DEDUCTIBLE IN RESPECT OF CERTAIN UNPAID LIABILITIES

Section 43B is applicable only if the taxpayer maintains books of account on the basis of mercantile system of accounting. The provisions of Section 43B are given below—

GENERAL RULE—CERTAIN EXPENSES ARE DEDUCTIBLE ON PAYMENT BASIS—

The following expenses (which are otherwise deductible under the other provisions of the Income-tax Act) are deductible on payment basis—

(*a*) any sum payable by way of tax, duty, cess or fee (by whatever name called under any law for the time being in force);

(*b*) any sum payable by an employer by way of contribution to provident fund or superannuation fund or any other fund for the welfare of employees;

(*c*) any sum payable as bonus or commission to be employees for service rendered;

(*d*) any sum payable as interest on any loan or borrowing from a public financial institution (*i.e.*, ICICI, IFCI, IDBI, LIC and UTI) or a state financial corporation or a state industrial investment corporation;

(*e*) interest on any loan or advance taken from a scheduled bank including a cooperative bank; and

(f) any sum payable by an employer in lieu of leave at the credit of his employee.

The above expenses are deductible in the year in which payment is actually made.

NOTES

EXCEPTION—WHEN DEDUCTIBLE ON ACCRUAL BASIS—The exception is applicable if the following two conditions are satisfied—

Condition one	Payment in respect of the aforesaid expenses is actually made on or before the due date of submission of return of income 1.
Condition two	The evidence of such payment is submitted along with the return of income.

If the above two conditions are satisfied and if the assessee maintains books of account on mercantile basis, then the expenditure is deductible on "accrual" basis in the year in which the liability is incurred.

BROAD CONCLUSIONS—The cumulative impact of the rule and exception stated above is presented in the following table.

Date of payment	*In which year it is deductible*	*Basis of deduction—*
Situation one—If the payment in respect of the aforesaid sums is made during the relevant previous year (*i.e.*,the year in which the liability is incurred)	In the year in which the payment is made	payment or accrual
Situation two—If the payment in respect of the aforesaid sums is made after the end of relevant previous year (*i.e.*, the year in which the liability is incurred) but on or before the due date of submission of return of income 1 for that year and the proof of deposit is submitted along with thereturn of income	In the relevant previous year on accrual basis (*i.e.*, the year in which the liability is incurred	Accrual basis
Situation three—If the payment is made at any other time (not being covered by the above situations)	In the year in which the payment is made	Payment basis
Situation four—If the payment is not made at all	Not deductible	Not deductible

NOTES

Illustration 7.4

XYZ Ltd. is doing business in the manufacture of rayon yarn, tyre cord and chemicals and proposes to set up a plant for manufacturing pulp from bamboo. In its return for the assessment year 2010-11 it claims deductions of ₹ 2,55,000 as research expenses paid to a foreign company in connection with research, being carried on in foreign company's laboratory, on pulping of bamboo and conversion of such pulp into yarn. The Assessing Officer wants to disallow the claim holding (*a*) that, even thought the pulp is admittedly the principal raw material for the manufacture of viscose rayon, the bamboo pulp project contemplated by it is new and altogether different from its business during the previous year; and (*b*) that the expenditure is not related to its business within the meaning of Section 35(1)(*i*), and research is not carried on by the assessee-company itself. Is the view taken by the Assessing Officer justified?

Solution: The activities of the assessee-company in the year in which the expenditure is incurred is, inter and the manufacture of rayon yarn. The research activity is related to the substitution of the raw material currently being used. Even if the assessee's present activities alone are considered as acceptable, even then the research undertaken should be properly regarded as being related to its business. To take any other view must be regarded as impractical and contrary to common sense—*CIT v. National Rayon Corpn. Ltd. [1982] 8 Taxman 11 (Bom.)*. The other argument of the Assessing Officer that the research must have been carried on by the assessee-company itself is not borne out by the phraseology of the statutory provision. In *CIT v. Ciba of India Ltd. [1968] 69 ITR 692*, it has been made clear by the Supreme Court that an assessee can claim the amount as permissible deduction although the research was carried on by some other persons, provided the research was carried on for or on behalf of the assessee.

7.9 PRESUMTIVE TAXATION

What are the special provisions for computing income on estimated basis under Sections 44AD, 44AE and 44AF These provisions are given below—

Computation of Income on Estimated Basis in the Case of Taxpayers Engaged in the Business of Civil Construction [Sec. 44AD]—

The provisions of Section 44AD are given below—

WHO IS COVERED BY THE SCHEME OF SECTION 44AD - Section 44AD is applicable only if the following conditions are satisfied—

Condition 1 The taxpayer may be an individual, HUF, AOP, BOI, firm, company, co-operative society or any other person. He or it may be a resident or a non-resident.

Condition 2 The taxpayer is engaged in the business of civil construction or supply of labour for civil construction work. The taxpayer may be a contractor or sub-contractor.

Condition 3 Gross receipts from the above business do not exceed ₹ 40 lakh.

NOTES

Conditions are satisfied, then Section 44AD is applicable. The following are the consequences if Section 44AD is applicable—

INCOME TO BE CALCULATED ON ESTIMATED BASIS @ 8 PER CENT—

The income from the above-mentioned business is estimated at 8 per cent of the gross receipts paid or payable to a taxpayer. A taxpayer can voluntarily declare a higher income in his return.

RATE OF 8 PER CENT IS COMPREHENSIVE—All deductions under Sections 30 to 38 including depreciation, are deemed to have been already allowed and no further deduction is allowed under this Section. After calculating income in accordance with the aforesaid provisions, one has to follow the following steps—

Step 1 The income as calculated above will be aggregated with income of the assessee from any other business or under other heads of income in accordance with the normal provisions of the Income-tax Act.

Step 2 The brought forward business losses and other losses shall be deducted according to the normal provisions of the Income-tax Act.

Step 3 All deductions permissible under Sections 80C to 80U shall be allowed.

Step 4 Tax on net income shall be calculated according to the normal provisions.

PROVISIONS FOR MAINTENANCE OF BOOKS OF ACCOUNT/ COMPULSORY AUDIT–NOT APPLICABLE—

The following privileges are available to a taxpayer who declares his income from the aforesaid business at the rate of 8 per cent of gross receipts (or at a higher rate)—

Privilege 1 He is not required to maintain books of account according to the provisions of Section 44AA in respect of the aforesaid business.

Privilege 2 He is not required to get his books of account audited under Section 44AB in respect of the aforesaid business.

It may be noted that the above privileges are available only in respect of the aforesaid business. Even such an assessee has to comply with the requirements of both Sections 44AA and 44AB in respect of his business, which are not covered by this scheme.

Provisions illustrated—A person has gross receipts of ₹ 30 lakh from civil construction business and of ₹ 25 lakh from trading in scrap. Although his total gross receipts are ₹ 55 lakh, he will not be required to have his accounts audited, since his gross receipts after excluding those from the business of civil construction are still less than ₹ 40 lakh, the limit provided in Section 44AB.

IS IT POSSIBLE TO DECLARE LOWER INCOME - A taxpayer can declare his income to be lower than the deemed profits and gains as stated above. The following consequences are applicable if the taxpayer declares his income, which is lower than the deemed profits and gains as stated above—

Consequence 1	The taxpayer will have to maintain the books of account as per Section 44AA (irrespective of income or turnover).
Consequence 2	The taxpayer will have to get his books of account audited under Section 44AB (irrespective of turnover).

Illustration 7.5

XYZ Ltd. is incorporated on September 3, 2009. It commences its production on March 14, 2011. During the previous year 2009-10, the following preliminary expenses are incurred by it : (*a*) registration fees for incorporation : ₹ 17,600 ; (*b*) printing expenses of memorandum, articles, prospectus, etc. : ₹ 28,000 : (*c*) legal charges for drafting the memorandum and articles : ₹ 36,000 ; (*d*) underwriting commission for issue of shares : ₹ 75,000 ; (*e*) cost of advertisements : ₹ 92,000 and (*f*) expenditure on the refund of the amount of oversubscription of shares : ₹ 81,000. Besides, the company has incurred the following expenses before commencement of business :

- preparation of feasibility report (the work is undertaken by the assessee) : ₹ 97,000;
- preparation of the project report (the work is undertaken by an approved concern) : ₹ 1,45,000;
- expenditure on conducting market survey necessary for the business for the company : ₹ 62,000 (the work is undertaken by a concern which is not approved for this purpose);
- legal charges of entering into a foreign collaboration : ₹ 43,000;
- engineering services in connection with the erection of plant and machinery : ₹ 3,12,900; and
- cost of plant and machinery : ₹ 87,92,000

Determine the amount deductible under Section 35D for he assessment years 2010-11 and 2011-12 assuming the following figures of fixed assets and capital :

	On March 31, 2010 ₹	*On March 31, 2011* ₹
Cost of fixed assets	51,00,000	96,01,850
Share capital	26,00,000	57,00,000
Debentures	9,00,000	11,00,000
Long-term borrowing from a financial institution	3,08,000	24,00,000

Solution:

Since the company commences its business by starting commercial production on March 14, 2011, the benefit of amortisation of pre-commencement expenses under Section 35D is available in 5 assessment years beginning with the assessment year 2011-12. The expenditure qualified for this purpose are the following :

	₹
Registration fees	17,600
Printing charges	28,000
Legal charges for drafting	36,000
Underwriting commission	75,000
Cost of advertisement	92,000
Expenditure on refund of amount of over-subscription	81,000
Cost of preparation of feasibility report	97,000
Cost of preparation of project report	1,45,000
Cost of conducting market survey (not included as the work is undertaken by an unapproved concern)	Nil
Legal charges for foreign collaboration	43,000
Engineering service for erection of plant	3,12,900
Total qualifying amount	9,27,500
Maximum qualifying amount	
Cost of project (being cost of fixed assets on March 31, 2011)	96,01,850
Capital employed on March 31, 2011 (*i.e.*, ₹ 57,00,000 + ₹ 11,00,000 + ₹ 24,00,000)	92,00,000
5% of cost of project or capital employed at the option of assessee (*i.e.*, 5% of ₹ 96,01,850)	4,80,093
Amount to be amortised in 5 assessment years beginning with the assessment year 2011-2012	96,018.50

Note. Since the entire qualifying amount is not eligible for amortisation, it is advisable to include cost of engineering service for erection of plant in the "actual cost" of plant, which will be eligible for depreciation under Section 32. If the company includes such cost in "actual cost" of the plant, the same will be excluded from qualifying amount which will be reduced to ₹ 6,14,600. However, the maximum amount eligible for amortisation will be increased to ₹ 99,14,750 (*i.e.*, ₹ 96,01,850 + ₹ 3,12,900) and, consequently, the amount be amortised in 5 installments will become ₹ 99,147.50 (*i.e.*, 1/5 of 5% of ₹ 99,14,750).

Computation of income on estimated basis in the case of taxpayers engaged in the business of plying, leasing or hiring trucks [Sec. 44AE] - The provisions of Section 44AE are given below—

WHO IS COVERED BY THE SCHEME OF SECTION 44AE—

Section 44AE is applicable only if the following conditions are satisfied—

Condition 1 The taxpayer may be an individual, HUF, AOP, BOI, firm, company, co-operative society or any other person. He or it may be a resident or a non-resident.

Condition 2 Taxpayer is engaged in the business of plying, hiring or leasing goods carriages.

Condition 3 The taxpayer owns not more than 10 goods carriages at any time during the previous year.

NOTES

CONSEQUENCES IF SECTION 44AE IS APPLICABLE—

If the aforesaid conditions are satisfied then Section 44AE is applicable. The following are the consequences if Section 44AE is applicable:

INCOME TO BE CALCULATED ON ESTIMATED BASIS—Income from the aforesaid business shall be calculated as follows:

Type of goods carriage	*Estimated income*
Heavy goods vehicle	₹ 3,500 for every month (or part of a month) during which the goods carriage is owned by the taxpayer.
Other than heavy goods vehicle	₹ 3,150 for every month (or part of a month) during which the goods carriage is owned by the taxpayer.

ESTIMATED INCOME IS COMPREHENSIVE—All deductions under Sections 30 to 38 including depreciation, are deemed to have been already allowed and no further deduction is allowed under this Section. After calculating income in accordance with the aforesaid provisions, one has to follow the following steps—

Step 1 It will be aggregated with income of the assessee from any other business or under other heads of income in accordance with the normal provisions of the Income-tax Act.

Step 2 The brought forward business losses and other losses shall be deducted according to the normal provisions of the Income-tax Act.

Step 3 All deductions permissible under Sections 80C to 80U shall be allowed.

Step 4 Tax on net income shall be calculated according to the normal provisions.

Illustration 7.6

Provision illustrated. *According to voluntary retirement scheme of* X Ltd., each employee will get voluntary retirement compensation in three instalments (35 per cent at the time of voluntary retirement, 10 per cent on November 1 of the first financial year immediately after retirement and remaining 55 per cent on December 1 of the second financial year immediately after retirement). The scheme is opened for the financial year 2009-10 only.

If the aforesaid conditions are satisfied, then the payment is not allowed as deduction.

Provisions illustrated. The following illustration is given in respect of salary payable for the previous year 2009-10 by a company to (*a*) any person outside India or (*b*) a non-resident in India—

Amount ₹	Date on which tax is supposed to be deducted (i.e., the date of salary payment)	Actual date of tax deduction	When tax should be deposited under Section 200(1)	Actual date of tax deposit	Previous year in which salary payment is deductible
40,000	July 31, 2009	July 31, 2009	August 7, 2009	November 10, 2009	2009-10
90,000	March 31, 2010	March 31, 2010	April 7, 2010	April 7, 2010	2009-10
1,60,000	March 31, 2010	March 31, 2010	April 7, 2010	April 12, 2010	2009-10
70,000	March 31, 2010	Not deducted	April 7, 2010	April 12, 2010	2009-10
75,000	March 31, 2010	March 31, 2010	April 7, 2010	Not deposited	2009-10
95,000	March 31, 2010	Not deducted	April 7, 2010	Not deposited	Not deductible

If salary payable outside India is exempt under Section 10 in the hands of the recipient, the aforesaid disallowance is not applicable—*Oceanic Contractors Inc. v. ITO* [1990] 33 ITD 213 (Bom.).

Scheme for computing profits and gains of retail traders [Sec. 44AF]–

The provisions of Section 44AF are given below—

WHO IS COVERED BY THE SCHEME OF SECTION 44AF - Section 44AF is applicable only if the following conditions are satisfied—

Condition 1 The taxpayer may be an individual, HUF, AOP, BOI, firm, company, cooperative society or any other person. He or it may be a resident or a non-resident.

Condition 2 The taxpayer is engaged in the business of retail trade in any goods or merchandise.

Condition 3 Total turnover from the above business does not exceed ₹ 40 lakh.

CONSEQUENCES IF SECTION 44AF IS APPLICABLE—If the aforesaid three conditions are satisfied then Section 44AF is applicable. The following are the consequences if Section 44AF is applicable:

INCOME TO BE CALCULATED ON ESTIMATED BASIS @ 5 PER CENT—

The income from the above-mentioned business is estimated at 5 per cent of the total turnover. A taxpayer can voluntarily declare a higher income in his return.

RATE OF 5 PER CENT IS COMPREHENSIVE—All deductions under Sections 30 to 38 including depreciation, are deemed to have been already allowed and no further deduction is allowed under this Section. After calculating income in accordance with the aforesaid provisions one has to follow the following steps—

Step 1 It will be aggregated with income of the assessee from any other business or under other heads of income in accordance with the normal provisions of the Income-tax Act.

Step 2 The brought forward business losses and other losses shall be deducted according to the normal provisions of the Income-tax Act.

Step 3 All deductions permissible under Sections 80C to 80U shall be allowed.

Step 4 Tax on net income shall be calculated according to the normal provisions.

Illustration. 7.7.

During the previous year 2009-10, A Ltd. pay ₹ 40,000 per month as salary to X (28 years) and provides a rent-free unfurnished house (lease rent being ₹ 10,000 per month). The tax on perquisite is paid by A Ltd. as follows—

	₹
Salary	4,80,000
Value of perquisite (15 per cent of salary)	72,000
Gross salary	5,52,000
Less : Deductions	—
Net income	5,52,000
Tax on net income (including EC or SHEC)	71,690
Average rate of tax (₹ 71,690/₹ 5,52,000 × 100) : 12.99%	
Tax on perquisite (12.99% of ₹ 72,000)	9,351

Total expenditure incurred by A Ltd. in respect of employee X is as follows

	₹
Salary to X	4,80,000
Rent-free house to X (₹ 10,000 to 12)	1,20,000
Tax on perquisite borne by A Ltd.	9,351
Total	6,09,351

While calculating business income of A Ltd., ₹ 9351 is not deductible by virtue of Section 40(a)(*v*) [amount deductible being ₹ 4,80,000 + ₹ 1,20,000]. In the hands of X, ₹ 9,351 is not chargeable to tax. The same rule is applicable if tax on perquisite paid by A Ltd. is lower than ₹ 9,351. If, however, tax paid by A Ltd. is more than ₹ 9,351 then the "excess" amount is deductible in the hands of A Ltd. and the same is chargeable to tax in the hands of X.

Illustration 7.8.

X Ltd. owns two plants—Plant A and Plant B—on April 1, 2009 (rate of depreciation : 15 per cent, depreciated value on April 1, 2009 : ₹ 2,37,000). The company purchases Plant C on May 31, 2009 for ₹ 20,000 and sells Plant A (on April 10, 2009), Plant B (on December 12, 2009) and Plant C (on March 1, 2010) for ₹ 10,000, ₹ 15,000 and ₹ 24,000 respectively.

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Written down value of the block of assets will be determined as under:	₹
Depreciated value of the block consisting of Plants A and B	2,37,000
Add : Cost of Plant C	20,000
Total	2,57,000
Less : Sale proceeds of Plants A, B and C	49,000
Written down value of the block (which is empty)	2,08,000

In the aforesaid case, no depreciation is admissible, as the block of asset ceases on the last day of the previous year. ₹ 2,08,000 will be treated as short-term capital loss on sale of Plants A, B and C under Section 50(2)‡. Depreciated value of the block on the first day of the next previous year (*i.e.*, on April 1, 2010) will be taken as nil (*i.e.*, written down value on March 31, 2010 : ₹ 2,08,000 minus short-term capital loss : ₹ 2,08,000).

In the case study given above, if Plants A, B and C are transferred for a consideration which is higher than ₹ 2,57,000 (say, ₹ 3,57,000), then no depreciation will be available and ₹ 1,00,000 shall be taken as short-term capital gain on sale of Plants A, B and C.

SUMMARY

This Chapter provides the method for computing income under the head profits and gains from business or profession. The method of accounting regularly employed by the assessee is relevant for the purpose of computing such income. While Sections 30 to 37 specify the various allowances or deductions available, Section 40, 40A and 43B specify explicitly as to what is not allowable as deduction.

REVIEW QUESTIONS

1. From the Profit and Loss Account of X (age: 31 years) for the year ending March 31, 2009, ascertain his total income and tax liability for the assessment year 2009-10:

	₹		
General expenses	13,400	Gross profits	3,64,500
Bad debts	22,000	Commission	8,600
Advance tax	21,000	Brokerage	37,000
Insurance	600	Sundry receipts	2,500
Salary to staff	26,000		
Salary to X	32,000		
Interest on overdraft	4,000		
Interest on loan to Mrs. X	42,000		
Interest on capital of X	23,000		
Depreciation	48,000		
Advertisement expenditure	7,000		
Contribution to RPF			
Net profit	1,60,600		
	4,12,600		4,12,600

NOTES

Other information:

The amount of depreciation allowable is ₹ 37,300 as per the Income-tax Rules.

2. General expenses include (a) ₹ 500 given to Mrs. X for arranging a party in honor of a friend who has recently come from Canada.

FURTHER READINGS

- *Income-tax Act, 1961*, Taxmann Publications Pvt. Ltd., New Delhi (latest edition).
- Singhania, Vinod. K. and Monica Singhania, *Students Guide to Income-tax*, Taxmann Publications Pvt. Ltd., New Delhi (latest edition.)

CHAPTER

8

INCOME FROM CAPITAL GAIN

STRUCTURE

8.0 LEARNING OBJECTIVES

After going through this lesson, you will be able to understand:

- the meaning of capital asset
- types of capital asset
- what is not capital asset
- computation of capital gain
- types of capital gains etc.
- you will also be learning how to calculate the capital gain of simple problems.
- the capital gain is also an income and it is taxable too, at the end of the chapter you will also learn the tax treatment of the capital gain.

8.1 INTRODUCTION

NOTES

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.

8.2 BASIS OF CHARGE

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.

8.3 CAPITAL ASSETS

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 assesses, 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 and National Defence Bonds 1980.
6. Gold Deposit Bonds 1999.

8.3.1 Types of Capital Asset

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,

NOTES

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 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

8.3.2 Types of Capital Gain

The profit on transfer of STCA is treated as Short Term Capital Gains (STCG) while that on LTCA is known as Long Term Capital Gains (LTCG). While calculating tax the STCG is included in Total Income and taxed as per normal rates while LTCG is taxable at a flat rate @ 20%. The taxability is discussed in details later in this lesson.

8.3.3 Transfer

Capital gain arises on transfer of capital asset; so it becomes important to understand what is the meaning of word transfer. 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 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.

8.4 COMPUTATION OF CAPITAL GAINS

NOTES

The capital gain can be computed by subtracting the cost of capital asset from its transfer price, *i.e.*, the sale price. The computation can be made by making a following simple statement.

Statement of capital gain

Particulars	*Amount*
Full Value of Consideration	—
Less: Cost of Acquisition* (COA)	—
Cost of Improvement* (COI)	—
Expenditure on transfer	—
Capital Gains	—
Less: Exemption U/S 54	—
Taxable Capital Gains	—

*To be indexed in case of LTCA.

8.4.1 Full Value of Consideration

Full value of consideration means and includes the whole/complete sale price or exchange value or compensation including enhanced compensation received in respect of capital asset in transfer. The following points are important to note in relation to full value of consideration.

- The consideration may be in cash or kind.
- The consideration received in kind is valued at its fair market value.
- It may be received or receivable.
- The consideration must be actual irrespective of its adequacy.

8.4.2 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 value for which it was acquired by the assessee. Expenses of capital nature for completing or acquiring the title are included in the cost of acquisition.

$$\text{Indexed Cost of Acquistion} = \frac{\text{COA} \times \text{CII of Year of transfer}}{\text{CII of Year of acquisition}}$$

The indices for the various previous years are given below:

If capital assets were acquired before 1.4.81, the assesses 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.

NOTES

Year	Index	Year	Index
1981-82	100	1995-96	281
1982-83	109	1996-97	305
1983-84	116	1997-98	331
1984-85	125	1998-99	351
1985-86	133	1999-2000	389
1986-87	140	2000-01	406
1987-88	150	2001-02	436
1988-89	161	2002-03	447
1989-90	172	2003-04	463
1990-91	182	2004-05	480
1991-92	199	2005-06	497
1992-93	223	2006-07	519
1993-94	244	2007-08	551
1994-95	259	2008-09	582
		2009-10	

8.4.3 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.

$$\text{Indexed Cost of improvement} = \frac{\text{COA} \times \text{CII of Year of transfer}}{\text{CII of Year of improvement}}$$

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.

8.4.4 Expenditure on Transfer

Expenditure incurred wholly and exclusively for transfer of capital asset is called expenditure on transfer. It is fully deductible from the full value of consideration while calculating the capital gain. Examples of expenditure on transfer are the commission or brokerage paid by seller, any fees like registration fees, and cost of stamp papers etc., travelling expenses, and litigation expenses incurred for transferring the capital assets are expenditure on transfer.

Note: Expenditure incurred by buyer at the time of buying the capital assets like brokerage, commission, registration fees, cost of stamp paper etc. are to be added in the cost of acquisition before indexation.

Illustration 8.1 X purchased a house property for ₹ 1,00,000 on 31st July 2000. He constructed the first floor in March 2003 for ₹ 1,10,000. The

NOTES

house property was sold for ₹ 5,00,000 on 1st April 2005. The expenses incurred on transfer of asset were ₹ 10,000. Find the capital gain.

Solution: Since the house property is a capital Asset therefore the capital gain will be computed. The house property was sold after 36 months of its acquisition therefore the capital gain will be long term capital gain (LTCG). Date of improvement (*i.e.*, additional construction of first floor) is irrelevant.

Statement of capital Gain

Particulars	*Amount* (₹)
Full Value of Consideration	5,00,000
Less: Indexed Cost of Acquisition (COA) 1,00,000 × 497/406	1,22,413
Indexed Cost of Improvement (COI) 1,10,000 × 497/447	1,22,304
Expenditure on transfer	10,000
Long Term Capital Gains	2,45,283
Less: Exemption U/S 54	NIL
Taxable Long Term Capital Gains	2,45,283

Illustration 8.2 If in the above question the property was acquired by Mr. X on 31st January 2003, then what will be your answer?

Solution: In this case the house property was sold before 36 months of its acquisition therefore the capital gain will be short-term capital gain (STCG). Date of improvement (*i.e.*, additional construction of first floor) is irrelevant.

Statement of capital Gain

Particulars	*Amount* (₹)
Full Value of Consideration	5,00,000
Less: Cost of Acquisition (COA) 1,00,000	1,00,000
Cost of Improvement (COI) 1,10,000	1,00,000
Expenditure on transfer	10,000
Short Term Capital Gains	2,90,000
Less: Exemption U/S 54	NIL
Taxable Short Term Capital Gains	2,90,000

Illustration 8.3 Mr. X acquired gold jewellery for ₹ 6,000 in 1979 (Market Value as on 1st April 1981 was ₹ 10,000). The jewellery was sold by Mr. X for ₹ 49,800 in June 2005. Calculate the taxable amount of capital gain, if the expense on transfer is ¼%.

Solution: Since the jewellery was purchased before 1st April 1981, therefore the assessee has the option to choose actual cost or FMV as on 1st April was his cost of Acquisition. Since the FMV is higher therefore, it will be beneficial for Mr. X to choose FMV as his COA.

NOTES

Particulars	Amount (₹)
Full Value of Consideration	49,800
Less: Indexed Cost of Acquisition (COA) 10,000 × 497/100	49,700
Indexed Cost of Improvement (COI)	NIL
Expenditure on transfer (0.25% × 50,000)	125
Long Term Capital Gains	–25
Less: Exemption U/S 54	NIL
Taxable Long Term Capital Gains	–25

This is a loss of ₹ 25, we are not using the word long-term capital loss, as it is incorrect, it means loss due to damage etc.

Illustration 8.4 Mr. X invested ₹ 50,000 in gold jewellery and ₹ 50,000 in equity shares on 1st June 2004. The jewellery was sold by Mr. X for ₹ 1,20,000 and shares for ₹ 1,80,000 on 4th August 2005. There was a ½% brokerage on both the investments, both at the time of purchase and sale. Calculate the taxable amount of capital gain.

Solution: Since it is more than 12 months in case of share since its acquisition therefore, shares are long-term capital asset and in case of gold jewellery it is less than 36 months therefore it is a short-term capital asset.

Particulars	Gold	Shares
Full Value of Consideration	1,20,000	1,80,000
Less: Indexed Cost of Acquisition		
Gold 50,000 + ½% × 50,000	50,250	
Shares (50,000 + ½% × 50,000) × 497/480		52,030
Indexed Cost of Improvement (COI)	NIL	NIL
Expenditure on transfer		
Gold (0.5% × 1,20,000)	600	
Shares (0.5% × 1,80,000)		900
Long Term Capital Gains	69,150	1,27,070
Less: Exemption U/S 54	NIL	NIL
Taxable Long Term Capital Gains	69,150	1,27,070

Note: Expenses on acquisition are added to COA before indexation, while expenses on transfer (sale) are subtracted separately to find capital gain.

8.5 EXEMPTION FROM CAPITAL GAINS

Exemption means a reduction from the taxable amount of capital gain on which tax will not be levied and paid. The exemptions are given under Section 54, these exemptions are of various types but here we will discuss only one of the exemptions relating to the house property.

8.5.1 Exemption u/s 54

The exemption u/s 54 relates to the capital gain arising out of transfer of residential house. The exemption is available to only Individual assessee. The exemption relates to the capital gains arising on the transfer of a residential house.

Conditions: Exemption is available if:

1. House Property transferred was used for residential purpose.
2. House Property was a long term capital asset.
3. Assesses has purchased another house property within a period of one year before or two years after the date of transfer or has constructed another house property within three years of date of transfer *i.e.* the construction of the new house property should be completed within three years. The date of starting of construction is irrelevant.

Amount of Exemption: will be the least of:

1. Capital Gains
2. Cost of new house.

Withdrawal of exemption: If the newly acquired house property is transferred within three years of acquisition. Thus, the earlier exempted capital gain will be charged to tax in the year in which the newly acquired house property is transferred. For that the cost of acquisition of the newly acquired house property will be reduced by the amount of exemption already availed thus the cost will reduce and thus the capital gains on the new house property will be more. Above all the new house property will be a STCA since for withdrawal of exemption it should had been sold within three years of its acquisition thus now the capital gain of the new house property will be STCG which is charged as per the normal rates which may be 30% (a higher rate as compare to the flat rate of LTCG of 20%) in the case of individuals.

Illustration 8.5 The assess purchases a new house property for ₹ 2,00,000 on 30th April 2004 how much exemption will be available to him under Section 54.

Solution: Since Mr. X has purchased a new house within one year before of the date of sale of old house property, therefore, he will be eligible for exemption u/s 54. The exemption is least of:

1. Cost of new house property, *i.e.,* ₹ 2,00,000
2. LTCG *i.e.,* ₹ 2,45,283

Therefore, the exemption will be ₹ 2,00,000 and the taxable capital gain shall be

Particulars	*Amount* (₹)
Full Value of Consideration	5,00,000
Less: Indexed Cost of Acquisition (COA) 1,00,000 × 497/406	1,22.413
Indexed Cost of Improvement (COI) 1,10,000 × 497/447	1,22,304

NOTES

Expenditure on transfer	10,000
Long Term Capital Gains	2,45,283
Less: Exemption U/S 54	2,00,000
Taxable Long Term Capital Gains	45,283

Illustration 8.6 Mr. X sell the new house property in June 2005 for ₹ 7,00,000 what will be the tax implication.

Solution: In this case since the new house property has been sold within 3 years of its acquisition, therefore the exemption on the purchase new house property will be withdrawn by reducing the cost of acquisition of the new house property, in the following manner. Since the new house property is sold within 36 months of acquisition therefore it is a short term capital asset.

Statement of capital gain of new house property

Particulars	*Amount* (₹)
Full Value of Consideration	7,00,000
Less: Cost of Acquisition (COA) 5,00,000	
Less: Exemption on old house 2,00,000	3,00,000
Cost of Improvement (COI)	NIL
Expenditure on transfer	NIL
Short Term Capital Gains	4,00,000
Less: Exemption U/S 54	N.A
Taxable Short Term Capital Gains	4,00,000

8.6 CAPITAL GAIN ON DEPRECIABLE ASSETS

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.

Illustration 8.7 Mr. X has following assets as on 1st April 2005:

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
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 Balance	11,00,000	Nil	12,00,000
Depreciation	23,00,000	50,00,000	16,00,000
Building 10% – 2,00,000 × 10% × ½	1,00,000	10,00,000	Nil
Building 10% – 21,00,000 × 10%	2,10,000	40,00,000	Nil
Building 20% – 50,00,000 × 20%	19,90,000		
Plant 20% – nil*			
W.D.V as on 31/03/06			

* 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:

Particulars	*Amount (₹)*
Full Value of Consideration	12,00,000
Less: Cost of Acquisition (COA)	28,00,000
Cost of Improvement (COI)	NIL
Expenditure on transfer	NIL
Short Term Capital Gains	–16,00,000

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Illustration 8.8 If the sale price of plant X is 32,00,000 and Building C is 29,00,000 what will be answer.

Solution: In this case there will be short-term capital gain on plant X for ₹ 4,00,000 and in case of building block – 10% there will be short term capital gain again because the sale price of asset is more than the opening WDV and the purchases, even though the block physically exist there will not be any depreciation since the whole cost of the block has been recovered.

8.7 TAXATION OF LTCG

The LTCG is taxable at a flat rate of 20%, however in case of individual the taxation is as follows:

If the other incomes except LTCG is less than ₹ 1,00,000 (maximum non-taxable limit)

Then Tax on LTCG = 20% (LTCG – (1,00,000 – other income))

If the other incomes except LTCG is greater than ₹ 1,00,000

Then Tax on LTCG = 20% LTCG

Illustration 8.9 Compute the tax on LTCG under following cases:

(*i*)	Business income ₹ 4,00,000	LTCG ₹ 1,20,000
(*ii*)	Business income ₹ 40,000	LTCG ₹ 1,20,000

Solution:

If Business income ₹ 4,00,000

LTCG ₹ 1,20,000

Tax on LTCG = 20% of LTCG

= 20% (₹ 1,20,000) = ₹ 24,000

If Business income ₹ 40,000

LTCG ₹ 1,20,000

Tax on LTCG = 20% (LTCG – (1,00,000 – other income))

= 20% (1,20,000 – (1,00,000 – 40,000)) = 20% (60,000)

= ₹ 12,000

SUMMARY

Gain on sale of any capital asset is called Capital Gain, if the capital asset is long-term then the gain is LTCG and if the asset is short term then the gain is STCG. However, gain on sale of depreciable asset is always STCG. The STCG is taxed at normal rates while LTCG is taxed at flat rate of 20%.

NOTES

REVIEW QUESTIONS

1. What is capital Asset?
2. Write short note on:
   (a) Cost of Acquisition
   (b) Cost of improvement
   (c) Expenditure on transfer
   (d) Transfer
3. Explain the deduction u/s 54.
4. 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:
   (i) Cost of construction of first floor in 1975-76 ₹ 1,00,000
   (ii) 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.

FURTHER READINGS

- Dr. Vinod K. Singhania and Monica Singhania; *Students' Guide to Income Tax*; Taxmann Publications Pvt. Ltd.; latest edition.
- Mahesh Chandra & D.C. Shukla; *Income-tax Law and Practice*; Pragati Publications; latest edition.
- H.C. Mehrotra; *Income-tax Law and Accounts;* Sahitya Bhawan; latest edition.
- Girish Ahuja and Ravi Gupta; *An Elementary Approach to Income Tax and Sales Tax*; Bharat Publications; latest edition.
- Dinkar Pagare; *Law and Practice of Income Tax*; Sultan Chand & Sons; latest edition

CHAPTER

9

INCOME FROM OTHER SOURCES

STRUCTURE

9.0 LEARNING OBJECTIVES

After going through this lesson, you will be able to understand:

- the various incomes
- which are included in the income from other sources.
- also you will be able to understand how income from dividend, income by way of interest is taxed and the concepts of grossing and net.

9.1 INTRODUCTION

There are some incomes, which are exempt, while others are taxable. The taxability of income is either under the head salary, house property, business income or capital gain. All of these heads of income are mentioned under Section 16 of the income tax act. You have read about these income heads in the previous lessons.

The incomes, which are neither covered under the above heads of salary, house property, business income, or capital gain, are covered in the head of income from other sources. This head of income is a residual head because it tries to cover all other incomes which are uncovered and which are not exempt from tax.

NOTES

9.2 INCOMES SPECIFIED IN SECTION 56

Income of every kind which are to be taxed, and which are not included in the income heads of Salary, House Property, Capital Gains, Profession and Business shall be charged under the head Income from Other Sources.

Income chargeable under this head shall be computed as per the method of accounting followed by assesses. There are two methods of accounting namely cash basis and mercantile basis. In the cash basis of accounting the income is recognized only on its actual receipt and expenses are recognized only on its actual payment. However, in mercantile basis of accounting the income is recognized even before its actual receipt and expense is recognized even before its actual payment.

Illustration 9.1

ABC Ltd. has sold goods worth ₹ 5 lakh in cash and ₹ 12 lakh on credit and purchased goods worth ₹ 2 lakh in cash and ₹ 6 lakh on credit. Determine the profit on cash basis and mercantile basis of accounting.

Solution:

Profit on cash basis:

Sales will be ₹ 5 lakh and purchase will be ₹ 2 lakh. Thus, profit will be sales minus purchase *i.e.*, ₹ 3 lakh.

Profit on Mercantile basis:

Sales will be ₹ 17 lakh (both cash and credit) and purchase will be ₹ 8 lakh (both cash and credit). Thus, profit will be sales minus purchase *i.e.*, ₹ 9 lakh.

Following incomes are specifically mentioned in the I.T. Act U/s 56, which are included in the income from other sources:

1. Dividend
2. Interest on securities if not chargeable under the head business or profession.
3. Wining from lotteries, crossword puzzles, races including horse races,card games and any other sort of games or gambling or betting of any form..
4. Income from machine, plant or furniture let on hire.
5. Income from machinery, plant, or furniture along with building and letting thereof is inseparable.
6. Any sum received under a key-man insurance policy including bonus if not taxable as salary or business income.

Dividend is the share of profit, which is distributed by the company to its shareholders; this is an income for shareholders. Interest on securities means interest on debentures, bonds etc. which is an income of the person receiving this interest. Letting machine, plant, furniture generates the rental income. We will study the taxation of the first three incomes *i.e.*, dividend, interest and winning briefly in the paragraphs given below.

9.3 INCOMES NOT SPECIFIED IN SECTION 56

Following incomes are not mentioned in the Income Tax Act but are to be charged to tax. Therefore, these incomes are also included in the head of income from other sources.

1. Income from subletting
2. Interest on bank deposits and loans and securities.
3. Agricultural income from a place outside India.
4. Rent of plot of land
5. Mining rent and royalty.
6. Casual income under a will, contract, trust deed.
7. Salary payable to a member of Parliament.
8. Income from undisclosed sources.
9. Gratuity paid to a director who is not an employee of a company.
10. Any casual income exceeding ₹ 5,000.

9.4 TAXABILITY OF SELECT INCOMES

Now, we will discuss in brief the taxability of dividend, winning from lotteries, interest on securities and family pension.

9.4.1 Taxability of Dividend

Taxability of Dividends [Sec 56(2)(i)]

Dividends is taxable, irrespective of the fact, whether it is paid in cash or in kind or it is paid out of taxable income or tax free income whether it is paid out of revenue profits or capital gains. Dividend includes deemed dividend mentioned u/s 2(22).

Normally, dividend is taxable on the basis of its declaration while deemed dividend and interim dividend is taxable on the basis of payment. A company at the end of the year after calculating its profit recommends the distribution of some part of its profit to its shareholders. The profit distributed among shareholders is called dividend.

Generally, dividend is given at the end of financial year. But some high profit company also gives the dividend in between of the year without calculating its year-end profits. This dividend is called interim dividend.

Dividends from Indian Company are exempt from tax since 1.6.97. But dividend from any other company is taxable. Similarly any deemed dividends U/S 2(22) are also taxable.

Deduction of expenses on collection and interest on loan, taken for investment in shares, is available against dividend income.

If the dividend is more than the specified limit under Section 194 (which is at present ₹ 2,500 in a year) then the dividend actually received will be after deducting a specified percentage of tax of TDS (Tax Deducted at Source). In these cases, some tax is deducted and the balance amount of Dividend is paid to the shareholder. The balance amount paid to shareholder is called *net dividend* or *dividend received* and the total dividend is called the *grossdividend*. Thus,

Gross Dividend = Dividend received + TDS

TDS = Gross Dividend * TDS Rate

Gross Dividend = Dividend received* 100/(100- TDS)

TDS rate u/s 194 is 20% plus surcharge plus 2% Education cess. The surcharge vary from case to case.

Illustration 9.2

Mr. X received a dividend of ₹ 7,000 from a non-domestic company during the previous year. He spends ₹ 100 towards collection charges. Calculated the Gross Dividend and income form other sources.

Solution:

In this case let us assume for the sake of simplicity that the surcharge is nil. Thus, TDS will be 20% plus 2% education cess, which comes to 20.4%.

Gross Dividend = Dividend received *100/ (100–TDS rate)

Gross Dividend = 7,000 *100/ (100–20.4)

Gross Dividend = ₹ 8,794

Dividend chargeable as income from other source = Gross dividend minus Collection charges = ₹ 8,794 – ₹ 100 = ₹ 8,694.

9.4.2 Taxability of Winning

Taxability of Wining from Lotteries, cross word puzzles, horse races and card games etc. is similar to the taxability of dividend with some changes like the rate of TDS is 30% plus surcharge plus 2% Education cess, and the exemption amount is ₹ 5,000 (however it is 2,500 in case of horse races) and no deduction on account of any expense in relation to the winning is allowed. That is the entire winning amount is taxable.

Gross amount = ₹ 5,000 + (net income received on wining – 5,000)*100 (100-TDS)

₹ 5,000 will be ₹ 2,500 in the case of wining from horse races.

₹ 5,000 is an exemption, which is available because it is a casual receipt.

Winning on lotteries races, crossword puzzles are all casual income.

Illustration 9.3

Mr. X receives ₹ 7,000 from a lottery prize won by him during the previous year. He spends ₹ 100 towards collection charges and the purchase of ticket. Calculated the Gross winning and income form other sources.

Solution:

In this case let us assume for the sake of simplicity that the surcharge is nil. Thus, TDS will be 30% plus 2% education cess, which comes to 30.6%.

Gross winning = ₹ 5,000 + (net income received on wining – 5,000) *100 (100–TDS rate)

Gross winning = ₹ 5,000 + (7,000 – 5,000)*100 (100 – 30.6)

Gross winning = ₹ 7,881

Winning chargeable as income from other source or Gross Winning = ₹ 7,881

Note: The collection charges are not deductible in case of winning.

9.4.3 Taxability of Interest on Securities

Taxability of interest on securities is also similar to the taxability of dividend withsome changes like the rate of TDS is 10% plus surcharge plus 2% education cess(20% plus surcharge plus 2% education cess in case of unlisted securities) and the exemption amount is ₹ 5,000 and Deductions on interest income are collection charges interest on loan and any other revenue expense incurred fully for the purpose of interest is allowed.

Gross interest = Net received * 100/(100 – TDS rate)

In case of tax-free govt. Securities, grossing up is not required as there is no deduction or TDS. However, grossing up is required in case of following securities.

1. Tax-free non govt. Securities
2. Less tax non govt. Securities
3. Less tax govt. Securities

Rate of TDS

Govt. Securities – 10% plus education cess; Listed securities – 10% plus education cess; Unlisted non-govt. Securities – 20% plus education cess.

Illustration 9.4

Mr. X received a dividend of ₹ 7,000 from a listed security during the previous year. He spends ₹ 100 towards collection charges. Calculated the Gross Dividend and income form other sources.

Solution:

In this case let us assume for the sake of simplicity that the surcharge is nil. Thus, TDS will be 10% plus 2% education cess, which comes to 10.2%.

Gross Interest = Interest received *100/(100 – TDS rate)

Gross Interest = 7,000 *100/(100 – 10.2)

Gross Interest = ₹ 7795

Interest chargeable as income from other source = Gross Interest minus Collection charges = ₹ 7,795 – ₹ 100 = ₹ 7,695.

9.4.4 Taxability of Family Pension

Taxable as income from other sources, a standard deduction of 1/3rd of pension or ₹ 15,000 whichever is less, is allowed.

SUMMARY

NOTES

As this unit is divided into five heads which is summarised as follows:

1. **Heads of Income:** There are five heads of income into which income of persons can be divided namely Income from salary, house property, business or profession, capital gains and other sources.
2. **Meaning of Salary:** Any remuneration paid by an employer to an employee in consideration of his services is called salaries. It includes monetary value of those benefits and facilities, which are provided by the employer and are taxable.
3. **Income forming part of salary:** They include basic salary, advance salary, fees, commission, bonus, taxable value of cash allowances, perquisites and retirement benefits.
4. **Allowances:** These are of three types
   (*a*) **Taxable Allowances:** Dearness allowance, Medical allowance, Servant allowance, Warden Allowance, Family allowance, City Compensatory allowance etc.
   (*b*) **Allowances exempt up to specified limit:** House rent allowances, *Entertainment allowance*, Certain Special allowances, etc.
   (*c*) **Fully exempted allowances:** Foreign allowance, sumptuary allowance to High Court/Supreme Court Judges, Allowances from U.NO.
5. **Perquisites:** These are of three types:
   (*a*) **Taxable perquisites for all employees:** Facility of rent-free house or house at concessional rent, payment of employee's obligations, payment of life insurance premium of the employee, etc.
   (*b*) **Perquisites taxable in specified cases only:** Facility of servant, gardener, gas, electricity, water, education, etc.
   (*c*) **Tax-free perquisites:** Free Medical facility or reimbursement of medical expenses, free facility of refreshments, entertainment, telephone, family planning, scholarship, leave travel concession, free motor car, club facility, gifts etc.
6. **Valuation of perquisites:** See Rule 3 of Income Tax Rules.
7. **Deductions:** Following three deductions are admissible:
   (*a*) **Standard Deduction:** This has been withdrawn from Assessment Year 2009-10.
   (*b*) **Entertainment Allowance:**
      (*i*) Government employees – 1/5th of salary or ₹ 5,000, whichever is less.
      (*ii*) Others – Nil
   (*c*) Employment Tax – Full Amount
8. **Provident Funds:** These are of four types:
   (*a*) Statutory provident fund
   (*b*) Recognized provident fund
   (*c*) Unrecognized provident fund and
   (*d*) Public provident fund

'Income from house property', in the hands of the owner (or deemed owner) of the property, provided that the property is not used by the assessee for the purpose of his own business or profession. For determining the annual value of the house property, the actual rent received or receivable from the property, the municipal valuation, the fair rental value and the standard rent under the Rent

NOTES

Control Act are taken into account. From the Gross Annual Value of the property, the Municipal Taxes are deducted to arrive at the Net Annual Value. Section 24 of the Income Tax Act provides that 30% of the NAV and the interest on borrowed capital shall be deducted from the NAV to obtain the taxable income from house property. As per Section 23(2) of the Income Tax Act, the annual value of one selfoccupied house property is taken to be nil. No deductions are permissible from the annual value of such property, except the interest on borrowed capital, subject to the maximum limit of ₹ 1,50,000 or ₹ 30,000 as the case may be. The above provisions may result in loss from house property, which may be set off against income from another house property or against incomes under the other heads. The balance loss may be carried forward, to be set off against the income from house property, upto a maximum of eight assessment years.

The third part provides the method for computing income under the head profits and gains from business or profession. The method of accounting regularly employed by the assessee is relevant for the purpose of computing such income. While Sections 30 to 37 specify the various allowances or deductions available, Section 40, 40A and 43B specify explicitly as to what is not allowable as deduction.

All those incomes which are not exempt and are to be taxed and are at the same time not covered in any of the four heads of income namely salary, house property, capital gains and business and profession is included in the head of income from other sources. The income included here is taxable on cash or mercantile basis whichever method assessee follows. There are certain incomes, which are specifically mentioned in Section 56 of the income tax act to be included in the head of income from other sources, but there are various other incomes, which are not specified in Section 56 of the income tax act but are still included in the income from other sources. If the tax is deducted at source then it is clubbed back in the income and then the whole of the income is included in the income from other source, in other words, if tax is deducted at source ad the balance income is received then the tax so deducted is added back in the income so received and then the whole of income is included in the income from other sources.

REVIEW QUESTIONS

1. Enumerate any five items of income, which are included under the head income from other sources.
2. Define Dividend. Discuss the taxability of dividend.
3. What are the incomes, which are included under the subhead of winning? What is the rate of tax on such incomes?

FURTHER READINGS

- Dinkar Pagare; *Law and Practice of Income Tax*; Sultan Chand & Sons; latest edition.
- Girish Ahuja and Ravi Gupta; *An Elementary Approach to Income Tax and Sales Tax*; Bharat Publications; latest edition.
- H.C. Mehrotra; *Income-tax Law and Accounts*; Sahitya Bhawan; latest edition.
- Mahesh Chandra & D.C. Shukla; *Income-tax Law and Practice*; Pragati Publications; latest edition.
- Singhania Dr. Vinod K and Monica Singhania; *Students' Guide to Income Tax*; Taxmann Publications Pvt. Ltd.; latest edition.

UNIT IV

CHAPTER

10

DEDUCTIONS

NOTES

STRUCTURE

10.0 LEARNING OBJECTIVES

NOTES

After going through this lesson, you should be able to:

- list the deductions available from gross total income
- know who is eligible for deduction
- list the conditions for claiming deduction
- calculate the amount of each deduction

10.1 INTRODUCTION

Indian tax laws contain certain provisions, which are intended to act as an incentive for achieving certain desirable socio-economic objectives. These provisions are contained in Chapter VIA and are in the form of deductions (80C TO 80U) from the Gross Income. By reducing the chargeable income, these provisions reduce the tax liability, increase the post-tax income and thus induce the tax-payers to act in the desired manner. This unit is intended to give a broad idea of such deductions.

10.2 COMPUTATION OF NET INCOME

To compute the net income of the assessees, first of all we compute the income under the five head. The provisions for the same have been already discussed in the previous units. The aggregate of income under each head is known as "gross total income". Certain deductions which are not deductible under any particular head of income are allowed out of gross total income to arrive at the total income liable to tax.

Total income is accordingly computed as under:

1. Income from salaries	—
2. Income from House property	—
3. Profits and Gains of Business and Profession	—
4. Income from capital gains	—
5. Income from other sources	—
Gross Total Income =	—
Less deduction under Chapter VI-A(80C to 80U)(–)	-------
Total income	—

These deductions are discussed in the following Sections.

10.3 BASIC RULES

Following are the basic rules for deduction:

1. The aggregate amount of deductions under Sections 80C to 80U cannot exceed gross total income(gross total income after excluding

long-term capital gains, short term capital gain under Section 111A, winnings from lottery, crossword puzzles etc.)

2. These deductions are to be allowed only if the assessee claims these and gives the proof of such investments/ expenditure/ income.

NOTES

10.4 CATEGORIES OF DEDUCTIONS

There are various kinds of deductions. Some of them are to encourage savings, some are for certain personal expenditure, a few are for socially desirable activities, and some are for economic growth. For the sake of better understanding we have categorized them into four kinds. They are

- To encourage savings
- For certain personal expenditure
- For socially desirable activities
- For physically disabled persons

We will be discussing them one by one.

10.5 DEDUCTIONS TO ENCOURAGE SAVINGS

The government wants to encourage the habit of people to save for the rainy day. To give impetus to savings these deductions are given on certain investments or certain expenditure made by the assessee. Deduction is allowed when the saving is invested but normally any withdrawal is treated as income in the year of withdrawal.

10.5.1 Deduction in Respect of Life Insurance Premia, Etc. (Sec. 80C)

A new Section 80C has been inserted from the assessment year 2006-07 onwards. Section 80C provides deduction in respect of certain expenditure/ investments (which are specified in this Section) paid or deposited by the assessee in the previous year.

Deduction under this Section is available only to individual and Hindu Undivided Family.

Gross Qualifying Amount

The following payments/investments qualify for deduction under this Section.

The total amount of investments made during the P.Y. under these below mentioned schemes is known as Gross Qualifying Amount (GQA):

1. Life Insurance premium paid on a policy taken on his own life, life of the spouse or any child (child may be dependent/ independent). In the case of a Hindu undivided family, policy may be taken on the life of any member of the family. The premium paid should be maximum of 20% of sum assured.
2. Any sum deducted from salary payable to a Government employee for the purpose of securing him a deferred annuity (subject to a maximum of 20% of salary).

3. Contribution towards statutory provident fund and recognized provident fund.
4. Contribution towards 15-year public provident fund (maximum of ₹ 70,000).
5. Contribution towards an approved superannuation fund.
6. Subscription to National Savings Certificates, VIII Issue.
7. Contribution for participating in the Unit-Linked Insurance Plan (ULIP) of Unit Trust of India.
8. Contribution for participating in the unit-linked insurance plan (ULIP) of LIC Mutual Fund (*i.e.*, Dhanraksha plan of LIC Mutual Fund).
9. Payment for notified annuity plan of LIC (*i.e.*, Jeevan Dhara, Jeevan Akshay New Jeevan Dhara, etc.) or any other insurer.
10. Subscription towards notified units of Mutual Fund or UTI.
11. Contribution to notified pension fund set up by Mutual Fund or UTI.
12. Any sum paid (including accrued interest) as subscription to Home Loan Account Scheme of the National Housing Bank.
13. Any sum paid as tuition fees to any University/College/Educational Institution in India for full time education.

Amount of deduction

We add the amounts invested/spent in above mentioned schemes and this amount is known as Gross qualifying amount. The amount deductible is:

(*a*) Gross qualifying amount; or

(*b*) ₹ 1,00,000 whichever is less

10.5.2 Deduction in Respect of Pension Fund (Sec. 80CCC)

If the following conditions are fulfilled an assessee may claim deduction under this Section

- The taxpayer is an individual
- During the previous year, he has paid/deposited a sum under an annuity plan of the Life Insurance Corporation of India or any other insurer for receiving pension.
- If deduction has not been claimed under Section 80C.

Amount of deduction

If the aforesaid conditions are satisfied, then

(*a*) the amount deposited

Note:–The maximum deduction under Sections 80C, 80CCC and 80CCD is ₹ 1,00,000.

(*b*) or ₹ 10,000, whichever is lower, is deductible.

Tax treatment of pension received.

The pension amount received by the assessee or his nominee as pension will be taxable in the year of the receipt.

NOTES

10.5.3 Deduction in Respect of Contribution to Pension Scheme of Central Government (Sec. 80CCD)

This Section is for allowing deduction to new central Government employees, if the following conditions are satisfied:

- The taxpayer is an individual
- He is employed by the Central Government on or after January 1, 2004.
- He has in the previous year paid or deposited any amount in his account under a pension scheme notified by the Central Government.

Amount of Deduction

The amount deductible is:

(*a*) The total employee's contribution and employer's contribution to the notified pension scheme during the year.

(*b*) Or 10% of salary of the employee.

Whichever is less

The aggregate amount of deduction under Sections 80C, 80CCC and 80CCD cannot exceed ₹ 1,00,000.

10.6 DEDUCTIONS FOR CERTAIN PERSONAL EXPENDITURE

Under Section 80-D, 80-DD ,80-DDB 80-E and 80-GG of IT Act 1961 some deductions are allowed in respect of personal expenditure such as Medical Insurance, Medical treatment of handicapped dependent, etc. These deductions are allowed to give impetus to threshold areas like education, health and housing. Let us now discuss them one by one.

10.6.1 Deduction in Respect of Medical Insurance Premia Sec. 80D

If the following conditions are satisfied then an assessee may claim deduction under this Section:

- The taxpayer is an individual or a Hindu undivided family.
- Insurance premium is paid by the taxpayer in accordance with the scheme framed in this behalf by the General Insurance Corporation of India and approved by the Central Government. The scheme is known as "mediclaim" insurance policy.(The amount deposited in a similar scheme of any other insurer who is approved by the Insurance Regulatory and Development Authority shall also be eligible for deduction).
- The aforesaid premium is paid by cheque.
- Mediclaim policy is taken on the health of the taxpayer, on the health of spouse, dependent parents or dependent children of the taxpayer. In case of HUF on the health of any member of the family.

NOTES

Amount of Deduction:

If all the aforesaid conditions are satisfied, then the

(*a*) insurance premium paid

(*b*) or ₹ 10,000 whichever is lower, is deductible.

The aforesaid limit has been increased to ₹ 15,000 where the assessee or spouse or dependent parents or any member of the family is a senior citizen (*i.e.*, one who is resident and at least of 65 years of age at any time during the previous year) and medical insurance is taken for such senior citizen.

10.6.2 Deduction in Respect of Dependent Relative Section 80DD

Following are the provisions under this Section:

- This deduction is available to only Individuals and HUF, who is resident in India.
- This deduction is given to the assessee if a person with disability is dependent upon him.
- A person with disability means disabilities like autism, cerebral palsy, mental retardation, etc., as specified in Persons with Disabilities Act 1995.
- The assessee has incurred expenditure by way of medical treatment (including nursing), training and rehabilitation of a disabled dependent: or/and
- He has paid or deposited any amount under any scheme framed by the LIC of India or any other insurer for the payment of an annuity or a lump sum amount for the benefit of such dependent in the event of the death of the assessee.
- For claiming the deduction the assessee shall have to furnish a certificate by the prescribed medical authority with the return of income.

Amount of Deduction

If the above mentioned conditions are satisfied the amount of deduction is fixed at ₹ 50,000 irrespective of actual expenditure. In case of a person with severe disability (over 80%) a higher deduction of ₹ 75,000 shall be allowed irrespective of actual expenditure.

Illustration 10.1

During the P.Y. 2005-06, the gross total income of Mr. X is ₹ 4,00,000. During the P.Y. he pays the following premiums on Mediclaim insurance policy by cheque. Calculate the amount of tax benefit under Section 80D. Explanation: Dependent means

(*i*) In case of an individual, the spouse children, parents, brothers, sisters of the individual or any of them.

(*ii*) In case of HUF, a member of the HUF wholly or mainly dependent on such individual or HUF for support and maintenance.

Amount (in ₹)

1. Mr. X 6,000
2. Mrs. X 4,000
3. Son (not dependent) 3,000
4. Daughter (dependent) 2,000
5. Father (not dependent) 1,500
6. Mother (dependent) (age 68 years and resident in India) 2,000

NOTES

Solution:

The insurance premium paid for son and father will not qualify for deduction under Section 80D as they are not dependent upon Mr. X.

Amounts qualifying for deduction are:—

Amount (in ₹)

Mr. X	6,000
Mrs. X	4,000
Daughter	2,000

Total 12,000 (limited to 10,000)

Additional deduction for mother 2,000

Hence, total deduction under Section 80 D is ₹ (10,000 + 2,000) = ₹ 12,000.

10.6.3 Deduction in Respect of Medical Treatment–Section 80DDB

Deduction is available if following are satisfied

- Assessee is an individual or HUF resident in India.
- The assessee has actually paid for the medical treatment of specified disease or ailment, for himself or any dependent* or in case of HUF any member of the family.
- The assessee furnishes a certificate, in the prescribed form from prescribed authority, along with the return of income.

Amount of deduction

(*i*) (*a*) The amount paid

(*b*) or ₹ 40,000 whichever is less;

(*ii*) Where the amount is paid in relation to a senior citizen the deduction shall be allowed for the amount paid or ₹ 60,000 whichever is less.

(*iii*) The deduction shall be reduced by the amount received, if any, under an insurance from an insurer for the medical treatment of person mentioned in this Section or reimbursed by the employer.

* The definition of 'Dependent' is the same as in the above Section.

10.6.4 Deduction in Respect of Repayment of Loan Taken for Higher Education–Section 80E

Deduction is available if:—

- Assessee is an individual.
- He has taken a loan from any financial institution (bank) or an approved charitable institution.

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- The loan is taken is for the purpose of pursuing his higher education.
- During the previous year he has repaid some amount as interest on such loan.
- Such amount is paid out of his income chargeable to tax.

Amount of deduction

(*a*) The entire amount paid by way of interest on such loan

(*b*) or ₹ 40,000 whichever is less is deductible in this Section.

Period of Deduction

Further, the deduction shall be allowed for the previous year in which the assessee starts repaying the loan or interest thereon and seven previous years immediately succeeding it or until the loan together with interest thereon is paid by the assessee in full, whichever is earlier. Higher education means full-time studies for any graduate or post-graduate course in engineering, medicine, management or for post-graduate course in applied science or pure sciences including mathematics and statistics.

10.6.5 Amount of Rent Paid–Section 80GG

This deduction is allowed to an individual assessee in respect of rent paid by him for an accommodation used for his residential purposes provided the following conditions are fulfilled:

- The assessee is either a self-employed person or such a salaried employee who is not in receipt of house-rent allowance from any source.
- The actual rent paid by him is in excess of 10% of his total income.
- He or his spouse or minor children or the HUF, of which he is a member, do not own any residential accommodation at the place where the assessee resides, performs the duties of his office or employment or carries on his business or profession. Where, however, the assessee owns any residential accommodation at any other place and claims the concessions of self-occupied house property for the same, he will not be entitled to any deduction u/s 80GG even if he does not own any residential accommodation at the place where he ordinarily resides, performs the duties of his office or employment or carries on his business or profession.
- The assessee files a declaration in Form No. 10BA regarding the payment of rent.

Amount of Deduction

The assessee, who fulfils the above mentioned conditions, is allowed a deduction equal to least of the following three:

- excess of actual rent paid over 10% of adjusted gross total income;
- 25% of his adjusted gross total income; and
- ₹ 2,000 p.m.

Illustration 10.2

A's gross total income is ₹ 1,80,000. Deductions allowed u/s 80D and 80C are ₹ 9,000 and ₹ 12,000 respectively. He pays a rent of ₹ 3,500 p.m. for a

NOTES

Note: Deduction under this Section can be claimed even if accommodation at concessional rent is provided by the employer. In such a case the deduction will be given if the actual rent paid by the employee exceeds 10% of his total income. Where a rent-free house is provided to the employee, no deduction will be allowed under this Section.

Adjusted Gross Total income (Adj.GTI) for this purpose means his gross total income minus long-term capital gain, short-term capital gain taxable u/s 111A, and all deductions u/s 80CCC to 80U except any deduction under this Section. three-roomed set. He does not own any residential accommodation. Compute his total income for the assessment year 2006-2007.

Solution:

	₹
Gross total income	1,80,000
Less: Deduction u/s	
80D – MIP etc.	9,000
80C – Insurance etc.	12,000
80GG – Rent Paid 24,000	45,000
Total Income	1,35,000

Note: Adj. GTI = ₹[1,80,000 (GTI) – 9,000 (80D) – 12,000 (80C)] = ₹1,59,000

Deductions u/s 80GG will be the least of the following:

(*i*) ₹ 2,000 p.m. ₹ 24,000

(*ii*) Rent paid (₹ 42,000) – 10% of Adj.GTI (₹ 1,59,000) ₹ 26,100

(*iii*) 25% of Adj. GTI (₹ 1,59,000) ₹ 39,750 ₹ 24,000 is the least, hence, deductible.

10.7 DEDUCTIONS FOR SOCIALLY DESIRABLE ACTIVITIES

There are various funds created by Governments to take care of natural calamities like earthquake, floods, etc. Similarly certain funds have been created to promote social and economic welfare, and education. To promote these funds and so that people contribute liberally to these funds, deduction has been provided in Section 80G for donations given by assessee to these funds.

10.7.1 Donation to Certain Funds, Charitable Institution, Etc. (Section 80G)

To encourage donations for social cause all assessees are entitled to this deduction from their gross total income, if the donation is made in the previous year to the following funds or charitable institutions. For the sake of convenience we have divided the donations into four categories depending on the quantum of deduction.

NOTES

(A) *Donations made to following are eligible for 100% deduction without any qualifying limit.*

1. Prime Minister's National Relief Fund
2. National Defence Fund
3. Prime Minister's Armenia Earthquake Relief Fund
4. The Africa (Public Contribution—India) Fund
5. The National Foundation for Communal Harmony
6. Approved University or Educational Institution of National Eminence
7. The Chief Minister's Earthquake Relief Fund, Maharashtra
8. Donations made to Zila Saksharta Samitis.
9. The National Blood Transfusion Council or a State Blood Transfusion Council.
10. The Army Central Welfare Fund or the Indian Naval Benevolent Fund or The Air Force Central Welfare Fund.

(B) *Donations made to the following are eligible for 50% deduction without any qualifying limit.*

1. Jawaharlal Nehru Memorial Fund
2. Prime Minister's Drought Relief Fund
3. National Children's Fund
4. Indira Gandhi Memorial Trust
5. The Rajiv Gandhi Foundation.

(C) *Donations to the following are eligible for 100% deduction subject to qualifying limit (i.e., 10% of adjusted gross total income).*

1. Donations to the Government or a local authority for the purpose of promoting family planning.
2. Sums paid by a company to Indian Olympic Association

(D) *Donations to the following are eligible for 50% deduction subject to the qualifying limit (i.e., 10% of adjusted gross total income).*

1. Donation to the Government or any local authority to be utilized by them for any charitable purposes other than the purpose of promoting family planning.

Amount of deduction

The quantum of deduction is as follows—

Category A – 100% of amount donated

Category B – 50% of the amount donated in the funds

Category C – 100% of the amount donated in the funds subject to maximum limit of 10% of Adjusted GTI.

Category D – 50% of the amount donated in the funds subject to maximum limit of 10% of Adjusted GTI.

The total of these deductions under categories A, B, C, and D is the quantum of deduction under this Section without any maximum amount.

Adjusted gross Total income for this purpose means his gross total income minus long-term capital gain, short-term capital gain taxable u/s 111A, and all deductions u/s 80CCC to 80U except any deduction under this Section.

Illustration 10.3

NOTES

X, an Indian citizen gives the following particulars of his income and expenditure for the previous year 2005-2006.

	₹
Business income	1,10,000
Long-term capital gain	2,00,000
Short-term capital gain on sale of shares taxable u/s 111A	10,000
Other short-term capital gain	5,000
Donation to the Prime Minister's National Relief Fund	11,000
Donation to the Government of India for promotion of family planning	3,000
Donation to an approved institution	12,000
Payment of medical insurance premium on own life	5,000

Determine the net income X for the assessment year 2006-2007

Solution:

Computation of Total Income of X

	₹
Business Income	1,10,000
Capital gain: Long-term	2,00,000
Short-term u/s 111A	10,000
Other short-term	5,000
Gross Total Income	3,25,000
Deduction u/s 80D	5,000
Less: Deduction: u/s 80G. 18,000	23,000
Total Income	3,02,000

Note:

Deduction u/s 80G is computed as under:

A Donation to PMNRF fully qualifies for deduction and the rate of deduction is 100% 11,000

Qualifying amount of donations for family planning and Approved Institution cannot exceed 10% of Adjusted gross total income

[*i.e.*, 3,25,000 – 2,00,000 (LTCG) – 10,000 (STCG) – 5,000 (80D)] of ₹ 1,10,000 = ₹ 11,000

C Deduction on donation for family planning on ₹ 3,000 @ 100% 3,000

D Deduction on other donation ₹ 8,000 @ 50% 4,000 Total 18,000

10.8 DEDUCTION ALLOWED TO A PERSON WITH DISABILITY–SECTION 80U

NOTES

To help a disabled person by reducing his tax burder, this Section has been incorporated. Following are the provisions.

- The assessee is an individual being a resident
- He is a person with disability.
- He is certified by the medical authority to be a person with disability, at any time during the previous year.
- He furnishes a certificate issued by the medical authority in the prescribed form along the return of income.

Amount of deduction

A fixed deduction of ₹ 50,000 in case of a person with disability ₹ 75,000 in case of a person with severe disability. (having any disability over 80%)

SUMMARY

Under the income tax act first of all income under each head is computed. The aggregate of income under each head is known as 'Gross Total Income'. Out of this gross total income certain deductions are allowed which are in the nature of incentives aimed at achieving certain socio economic objectives. The income after such deductions is called 'Total Income'. These deductions are either for certain savings or for certain personal expenditure. Saving based deductions are 80-C (certain investments towards LIC, PF, etc.) 80CCC (pension fund), 80CCD (Pension scheme of central Government). Deductions based on personal expenditure are 80D (Medical insurance), 80DD (Medical treatment of disable dependent) 80DDB (Medical treatment of specified disease) 80E (Repayment of loan taken for higher education) and 80GG (Deduction for rent paid). Certain deductions are for socially desirable activities like 80 G for donations to certain funds, charitable institutions, etc. There is a special deduction for a person with disability under Section 80U One important point to remember is that the total of all deductions under these Sections 80C to 80U cannot exceed the gross total income.

REVIEW QUESTIONS

1. Fill in the blanks
   (*i*) Repayment of loan for higher studies under Section 80E is allowed to the extent of ₹ _______ every year for _______ years.
   (*ii*) The maximum deduction u/s 80GG shall be limited to ₹ _______ p.m.
   (*iii*) Deduction under 80D in respect of medical insurance premia is allowed to an _______ or _______ .
   (*iv*) Deduction under Section 80CCC is allowed to the extent of ₹ _______.
   (*v*) Deduction under Section 80G in respect of donations is allowed to _______.
2. Write short notes on:
   (*a*) Deduction under Section 80GG in respect of amount of rent paid

(*b*) Deduction u/s 80DD in respect of medical treatment of dependent who is a person with disability.

NOTES

FURTHER READINGS

- Bhagwati Prasad, *Law and Practice of Income Tax*, Navaman Prakashan, Aligarh.
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NOTES

UNIT V

CHAPTER

11

SET-OFF AND CARRY FORWARD OF LOSSES

STRUCTURE

11.0 LEARNING OBJECTIVES

NOTES

After going through this lesson, you should be able to understand: If there is a loss sustained by the assessee, whether such a loss can be

- set off against income from any other source/head and the restrictions for the same.
- if it cannot be set off, can that loss be carried forward and,
- what are the provisions/restrictions for the above and for how many years it can be carried forward.

11.1 INTRODUCTION

Income-tax is a composite tax on the total income of a person earned during a period of one previous year. There might be cases where an assessee has different sources of income under the same head of income. Similarly, he may have income under different heads of income. It might also happen that the net result from a particular source/head may be a loss. This loss can be set off against other sources/head in a particular manner. For example, where a person carries on two businesses and one business gives him a loss and the other a profit, then the income under the head 'Profits and gains of business or profession' will be the net income i.e. after the adjustment of the loss. Similarly, if there is a loss under one head of income, it should normally be adjusted against the income from another head of income while computing the Gross Total Income, of course subject to certain restrictions. These provisions for set off or carry forward and set off of loss are contained in Sections 70 to 80 of Income-tax Act.

11.2 MEANING OF IMPORTANT TERMS

Head of Income

An assessee may have income from various sources like employment, business, interest, rent, etc. For the purpose of income tax we divide these incomes into five heads namely.

- Income from Salaries
- Income from house property
- Income from Business and Profession
- Capital Gains
- Income from other sources

The rules for computation of income under each head is different (You have already studied these five heads).

Source of Income

An assessee may have 3-4 sources of income under one particular head. For example a person might have two businesses A and B which are two sources of income under the same head business and profession. Similarly

NOTES

a person might be having two part-time employments. He will receive salary from both the employers; each salary received is a source of income. But both are taxable under the head 'Income from Salary.'

11.3 NO LOSS CAN BE SET OFF AGAINST WINNINGS FROM LOTTERIES, CROSSWORD PUZZLES, ETC.

As discussed in the introduction, losses sustained by an assessee can be set off against other incomes subject to certain restrictions. The detailed provisions for the same will be discussed later. The first and the foremost restriction that I.T. Act puts are; No loss can be set off against any income from lottery, crossword puzzles, horse races, gambling, etc. Government does not promote such kind of activities which depend totally on luck/chance and likelihood of losing is very high. Hence, any income from these sources is fully taxable irrespective of any loss sustained by the assessee even from the same source or a different source or a different head. As already discussed in the lesson Income from other sources no expenditure or allowance is even allowed to be deducted from winnings from lotteries or crossword puzzle, etc. Hence, it is very clear and obvious that no question arises of any loss to be set off against such incomes.

Hence, we can conclude any income from lottery, crossword puzzles, horse races, gambling, etc. is fully taxable always. No expenses even if they relate to earning of such income are allowed to be deducted. Furthermore, no loss can be set off against such income even if it is from the same source.

11.4 STEPS IN SET OFF AND CARRY FORWARDS

There are three steps involved in this:

Step 1 Inter-source adjustment under the same head of income?

Step 2 Inter head adjustment in the same assessment year Step 2 is only applied if it is not possible to set off a particular loss under Step 1.

Step 3 Carry forward of a loss this step is only applicable if a loss is not set off under Step 1 and 2.

11.5 INTER SOURCE ADJUSTMENT (SEC. 70)

Where the net result for any assessment year in respect of any source is a loss, the assessee shall be entitled to have the amount of such loss set off against his income from any other source under the same head. This may also be referred to as inter source adjustment.

For example, if the assessee has two houses and the net income from one house is ₹ 84,000 while from the other house there is a loss of ₹ 60,000 the loss shall be adjusted against the income (as both fall under the same head *i.e.*, 'Income from house property') and after set off, the income under the head 'Income from house property' shall be ₹ 24,000. This is Inter source adjustment. On the other hand, if an assessee has two houses and there is a net Income of ₹ 80,000 from one house and loss of ₹ 1,20,000 from another, the net loss under this head will be (–) 40,000. Such a loss can be set off against any kind of income under any other head which is termed as Inter-head adjustment. This has been explained in detail later in the chapter. However, there are certain exceptions to this general rule of inter source adjustment. In the following cases loss from one source cannot be adjusted against income from another source of income although it falls under the same head:

11.5.1 Loss from Speculation Business

"Speculation business" means a business in which contracts for the purchase or sale of any commodity including stocks and shares is periodically or ultimately settled without the actual delivery or transfer of the commodity or scrips. As per Section 73 any loss arising from a speculation business carried on by an assessee shall be set off only against income of any another speculation business run by the assessee. It cannot be set off from a non-speculative business income, although income from both kinds of businesses are taxable under the head 'profits and gains of business or profession'. However, a loss from a non-speculative business can be set off against income from speculation business but vice versa is not possible.

Illustration 11.1

R carries only two businesses A and B. Business A is a manufacturing business while business B is a speculative business. State whether the loss can be set off in the following two situations.

	Situation I	*Situation II*
	₹	₹
Manufacturing business	(+) 800,000	(–) 5,00,000
Speculation business	(–) 3,40,000	(+) 2,00,000

Solution:

In situation I, set off is not possible as speculation loss can be set off only against income from speculation business.

In situation II, set off is possible and the manufacturing business loss will have to be set off against income from speculation business.

11.5.2 Loss from the Activity of Owning and Maintaining Race Horses

As per Section 74A, the loss incurred by an assessee, in the activity of owning and maintaining race horses, shall only be set off against the income from such an activity. It cannot be set off against the income from any other sources.

11.5.3 Long Term Capital Loss

Long-term capital loss can be set off only against long-term capital gain. However, short-term capital loss can be set off from any capital gain (long-term or short-term).

Illustration 11.2

NOTES

	Situation I	*Situation II*
Short-term capital gain	(–) 2,00,000	(+) 5,00,000
Long-term capital gain	(+) 5,20,000	(–) 1,80,000

Solution:

In situation I, short-term capital loss of ₹ 2,00,000 will have to be set off from long-term capital gain. Hence, the net long-term capital gain in this case shall be ₹ 3,20,000.

In situation II, it is not possible to set off long-term capital loss from short-term capital gain. Hence, short-term capital gain of ₹ 5,00,000 shall be taxable and ₹ 1,80,000 of long-term capital loss shall have to be carried forward.

11.5.4 Loss from a Source, Which is Exempt

Loss incurred by an assessee from a source of income which is exempt, cannot be set off against income from a taxable source.

11.6 INTER-HEAD ADJUSTMENT (SECTION 71)

As explained above, any loss from one source of income is firstly set off against any gain from another source within the same head. Any remaining loss can then be set off against Income from any other Head. This is known as Inter-Head adjustment. However, there are exceptions to this rule also as discussed below. As already discussed above, in the following cases no inter source adjustment is permitted, hence, the question does not arise of any inter-head adjustment. In other words following are the exceptions to inter-head adjustment also.

- No loss of whatsoever nature can be set off against winnings from lotteries, crossword puzzles, card games, etc.
- Loss from a speculation business;
- Loss from the activity of owning and maintaining race horses;
- Loss from a source which is exempt.
- Long-term capital loss-only from LTCC.

Besides the above mentioned exceptions which are applicable both in inter source adjustment and inter head adjustment, there are two more exceptions to inter head adjustment. They are;

- Loss under the head capital gain
- Loss under the head business and profession

11.6.1 Loss Under the Head 'Capital Gains'

In case of an Inter-head adjustment of losses, any capital loss, whether short-term or long-term, shall not be allowed to be set off against income under any other head. It shall however be allowed to be carried forward.

11.6.2 Loss Under the Head Business or Profession [Section 7 (2A)]

From the Assessment Year 2005-06, any loss under the head 'Business and Profession' cannot be set off against income from 'Salaries'. However, it can be set off against the Income from any other head.

Illustration 11.3

From the following information submitted to you, compute the taxable income in the following situation.

	Situation I	*Situation II*
	₹	₹
Long-term capital gain/loss	(+) 2,80,000	50,000
Short-term capital gain/loss	(–) 50,000	(–) 1,20,000
Business income/loss	(–) 1,80,000	1,40,000

Solution:

	Situation I	*Situation II*
	₹	₹
Capital gain		
Long-term capital gain/loss	(+) 2,80,000	50,000
Short-term capital gain/loss	(–) 50,000	(–) 1,20,000
Capital gain/loss after set off	2,30,000	(–) 70,000
Set off of business income/loss	(–) 1,80,000	1,40,000
Total income	1,50,000	1,40,000*

*In situation II, capital loss of ₹ 70,000 will be carried forward and the total income shall be ₹ 1,40,000.

Hence, we observe business loss can be set off against capital loss but vice-versa is not allowed.

Illustration 11.4

From the following information submitted to you by Mr. X, calculate the gross total income for the A.Y. 2009-10.

	I	II
Income from salary	2,00,000	2,00,000
Income from Business/Profession	(–) 50,000	(–) 50,000

Income from House Property – 80,000

Solution:

In situation I, his GTI would be 2,00,000 and his loss from business and profession will be carried forward (Any loss under the head Business and Profession cannot be set off against any income from Salary).

In situation II, business loss can be set off against income from House Property and his GTI would be ₹ 2,30,000.

11.7 CARRY FORWARD AND SET OFF OF LOSSES

NOTES

If the losses could not be set off under the same head or under different heads in the same assessment year, such losses are allowed to be carried forward to be claimed as set off from the income of the subsequent assessment years. Only the following losses are allowed to be carried forward and set off in the subsequent years.

(*a*) House property loss;

(*b*) Business loss;

(*c*) Speculation loss;

(*d*) Capital loss;

(*e*) Loss on account of owning and maintaining race horses.

Hence any loss under the head income from other sources is not allowed to be carried forward.(except race horses) All losses are not allowed to be carried forward. Another very important aspect is that in case of carry forward, losses can be only set off under the same head of income only. Inter head adjustment is not allowed.

Compulsory filing of loss of return (Section 80)

Although the above losses are allowed to be carried forward, it is allowed only when such loss has been determined in pursuance of a return of loss submitted by the assessee on or before the due date for filing of the returns prescribed under Section 139(1) However loss under the head income from house property can be carried forward even if the return is not filed within the due date mentioned under Section 139(1).

11.7.1 Carry Forward and Set Off of Loss from House Property (Section 71B)

A loss under the head house property will be allowed to be carried forward for 8 assessment years to claim it as a set off in the subsequent years under the head 'Income from house property'. Therefore, if the loss of house property of the previous year 2003-2004 which could not be set off because of absence or inadequacy of the income of previous year 2003-2004, it may be carried forward for 8 assessment years succeeding assessment year 2004-2005 to be set off from income under the head house property.

11.7.2 Carry Forward and Set Off of Business Losses (Section 72)

Where the loss under the head 'profits and gains of business or profession' other than loss from speculation business, could not be set off in the same assessment year because either the assessee had no income under any other head or the income was less than the loss, such loss which could not be set off in the same assessment year, can be carried forward to the following assessment years, However it is subject to following conditions.

(*i*) Business losses can be adjusted only against business income: Business income may be from the same business in which the loss was incurred, or may be any other business.

(ii) Business in respect of which a loss is incurred may or may not be continued.

(iii) Losses can be set off only by the assessee who has incurred loss with a few exceptions like when a partnership firm is converted into a company, amalgamation of companies, etc.

(iv) Period of carry forward: Each year's loss is a separate loss and no loss shall be carried forward for more than eight assessment years immediately succeeding the assessment year for which the loss was first computed. Therefore, a loss of previous year 2002-2003, *i.e.*, assessment year 2003-2004 can be carried forward till assessment year 2011-12. Besides the above, the following can also be carried forward indefinitely, as per income tax law:

(i) Unabsorbed depreciation;

(ii) Unabsorbed capital expenditure on scientific research;

(iii) Unabsorbed expenditure on family planning.

11.7.3 Set off and Carry Forward of Speculation Loss (Section 73)

As stated earlier, the loss of a speculation business of any assessment year is allowed to be set off only against the profits and gains of another speculation business in the same assessment year. If a speculation loss could not be set off from the income of another speculation business in the same assessment year, it is allowed to be carried forward for 8 assessment years immediately succeeding the assessment year for which the loss was first computed. Also, it can only be set off against the income of only a speculation business. It may be observed that it is not necessary that the same speculation business must continue in the assessment year in which the loss is set off. However, filing of return before the due date is necessary for carry forward of such a loss.

11.7.4 Loss Under the Head Capital Gain

Loss on short-term capital asset

Any loss on short-term capital asset is allowed to be carried forward to be set-off in subsequent years against capital gains (short-term as well as long-term). The period of carry forward is 8 years.

Loss on Long-term capital asset

Any loss from long-term capital assets can also be carried forward to be set-off in subsequent years but against only long-term capital gains. The period of carry forward is 8 years.

11.7.5 Loss on Owning and Maintaining Race Horses Section 74A (3)

Any loss suffered by the assessee in respect of maintaining of race horses can be set-off against the income from the activity of owning and maintaining race horses in subsequent years .The period for carry forward of such a loss is only four years immediately succeeding the assessment year in which the loss was computed for the first time.

SUMMARY

NOTES

Set-off of losses means setting-off losses against the income of the same year. Where it is not possible to set-off the losses during the same assessment year in which they occurred, so much of the loss as has not been so set-off (only certain specified losses) can be carried forward for being set-off against his income in the succeeding years. Set-off can be inter source and Inter-head. Inter-source means when loss of one source is set-off against the income of some other source under the same head of income. Inter-head means when a loss remains unabsorbed from inter-source set-off, the balance of it can be set-off against income under other head of income. If both the adjustments are not possible then certain losses namely loss from house property, loss from business including speculation business, capital loss, and loss from activity of maintaining race horses can be carried forward.

REVIEW QUESTIONS

1. State whether they are true or false:
   (*a*) Speculation business losses can be set-off against profits of regular business.
   (*b*) Non-speculative (regular) business losses can be set-off against speculation business profits.
   (*c*) When inter-source Adjustment exhausts, inter-head adjustments begin.
   (*d*) Loss under the head house property can be carried forward for 8 years to be set-off in the following and subsequent seven years.
   (*e*) If a speculation business is discontinued its brought forward losses cannot be carried forward any further to be set-off against profits of any other speculation business.
   (*f*) Loss from business and profession can be set off against income from salary.
2. Discuss the provisions relating to set-off of losses in the following cases:
   (*a*) Speculation loss
   (*b*) Short-term capital loss
   (*c*) Long-term capital loss
   (*d*) Losses
   From horse race, gambling and crossword puzzles.
3. Discuss the conditions subject to which losses are allowed to be set-off in the current year and carried forward.
4. Discuss the detail provisions regarding set off carry forward of losses relating to short term and long term capital assests.

FURTHER READINGS

NOTES

- Bhagwati Prasad, *Law and practice of Income Tax*, Navaman Prakashan, Aligarh.
- Mahesh Chandra & S.P. Goyal, *Income Tax Law and practice*, Himalaya Publishing House, Delhi.
- Vinod K. Singhania, Monica Singhania, *Students Guide to Income Tax*, Taxmann Publications Private Ltd.
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