SYLLABUS
T.Y. B.COM.
RELATED APPLIED COMPONENT GROUP – PAPER-V
DIRECT AND INDIRECT TAXES

SECTION-I **DIRECT TAXES** **40 Marks**

INCOME TAX

1. **Definitions –(S.2)**

   Assessee, Assessment, Assessment Year, Annual Value, Business, Capital Assets, Income, Person, Previous Year Transfer.

2. **Scope of Total Income - (S.5) , Residential Status- (S.6)**
3. **Heads of Income -S. 14 ,14A**
   a) Salary (S. 15 to S. 17)
   b) Income from house Property (S. 22 to S. 27)
   c) Profits and Gains from Business, Profession & Vocation (S. 28 , 30, 31, 32, 35 , 35D . 36, 37, 40, 40A, 43B)
   d) Capital Gains(S. 45, 48, 49. 50 and 54)
   e) Income from Other Sources (S.56 to S. 59)

   Exclusions from Total Income (S.10)

   Exemptions related to specified Heads of incomes to be covered with the relevant provisions such as Salary, Income from Other Sources.

4. **Deduction from Total Income**

   S. 80C, 80CCC: 80D, 80DD, 80E, 80U:

5. **Computation of Total Income for Individual**

Notes:

1. Syllabus restricted to study of specified sections , specifically mentioned rules and notifications only
2. All topics include computational problems/case study
3. The law in force on 1st April immediately preceding the commencement of Academic Year will be applicable for ensuing examinations.

PATTERN OF QUESTION PAPER **For regular students/ IDE students final examination at the University level to be conducted**		
Section –I: Direct Taxes - Income Tax		**40 Marks**
No. of questions to be asked		5
No. of questions to be answered		3
		Marks
Q.1	Compulsory practical question (with two heads of income and two deductions Under Chapter VIA)	16
Q.2	Compulsory objective questions based on all topic and include *inter alia* (a) multiple choice (b) fill in the blanks (c) match the columns (d) true or false	12
Q.3,4,5,	Any one question to be attempted out of Q.3,4 & 5, of which not more than one question may be theory including short questions/ problems	12 (each)

SECTION-I
DIRECT TAXES – INCOME TAX

1

INTRODUCTION AND BASIC CONCEPTS

Synopsis

1. Introduction and Objectives
2. Assessment Year
3. Previous Year
4. When income of previous year is not taxable in the immediately following assessment year – Double role of financial year
5. Person
6. Assesses
7. Assessment
8. Income
9. Gross Total Income
10. Total Income
11. Scheme of charging income tax
12. Income Tax Rates
13. Self Examination Questions

1. INTRODUCTION AND OBJECTIVES :

Under the Constitution of India central government is empowered to levy tax on the income. Accordingly, the central government has enacted the Income Tax Act, 1961. The Act provides for the scope and machinery for levy of Income Tax in India. The Act is supported by Income Tax Rules, 1961 and several other subordinate and regulations. Besides, circulars and notifications are issued by the Central Board of Direct Taxes (CBDT) and sometimes by the Ministry of Finance, Government of India dealing with various aspects of the levy of Income tax. Unless otherwise stated, references to the sections will be the reference to the sections of the Income Tax Act, 1961.

Income tax is a **tax** on **the total income** of a **person** called the assessee of **the previous year** relevant to the **assessment year** at the rates prescribed in the relevant Finance Act

This phrase sets the tone and agenda of any study on Income Tax Law This comprises of the understanding of the following:

- Concept of assessment year and previous year
- Meaning of person and assessee
- How to charge tax on income
- What is regarded as income under the Income-tax Act
- What is gross total income
- What is total income or taxable income
- Income-tax rates

This chapter seeks to study in details all these aspects which lay down the basic framework for levy of income tax in India and also explain the basic concepts and terms used in the income tax law.

2. ASSESSMENT YEAR – S. 2(9)

"Assessment year" means the period of twelve months starting from April and ending on March of the next year. In an assessment year, income of the assessee during the previous year is taxed at the rates prescribed by the relevant Finance Act. It is therefore, sometimes referred as the "Tax Year"

Illustration -1:
Assessment year 2012-13 will commence on 1st April, 2012 and end on 31st March, 2013

3. PREVIOUS YEAR- S. 2(34)& S. 3

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

Illustrations

2. For the previous year 2011-12, assessment year will be 2012-13. In other words for the assessment year 2012-13 the immediately preceding financial year (2011-2012) will be the previous year. Income earned by a person during the previous year 2011-12 will be taxable in the immediately following assessment year 2012-13 at the rates applicable for the assessment year 2012-13.

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

Common previous year for all source of income:

A person may have different sources of income but previous years will always be common for all the sources of income. This may be despite the fact that for the different sources of income, different records or books of accounts may be separately maintained. Income from all such sources will be considered in the previous year or the financial year immediately preceding the assessment year.

Illustration -4

A gets dividend income from company A Limited. He is employed by another company N Limited and is also running a personal business in the name of A Sons . A's income from all the sources will have a common previous year i.e. 2011-12 relevant to assessment year 2012-13

New Business or Profession;

Where , a business is newly set up during the previous year , or where a new source of income has arisen during the previous year , previous year will be the period (obviously less than one year) commencing from the date of setting up of the new business or the date of new source of income arising.

Illustration – 5

Ramesh gets his first job in the month of January, 2011. His previous year will be the period of three months commencing on 1st January, 2011 and ending on 31st March, 2012 and the relevant to assessment year 2012-13. It is Immaterial that previous year is of a period of less than 12 months.

4. DOUBLE ROLE OF FINANCIAL YEAR – WHEN INCOME OF PREVIOUS YEAR NOT TAXABLE IN THE IMMEDIATELY FOLLOWING ASSESSMENT YEAR

As a rule income of the previous year is taxable as the income of the immediately following assessment year. The rule is subject to certain exceptions, when income of a previous year may be taxed as the income of the assessment year immediately preceding the normal assessment year. In such cases the income becomes taxable during the previous year itself and it can be said

that a financial year is a previous year as well as an assessment year.

These exceptions have been incorporated in order to ensure smooth collection of income tax from a class of taxpayers who may not be traceable if tax assessment procedure is postponed till the commencement of the normal assessment year.

The Exceptions referred to above are:

a) Income of non-residents from shipping –S.172;
b) Income of persons leaving India either permanently or for a long period of time and not likely to return back –S. 173;
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 – S. 175 ,
e) Income of a discontinued business- S.176
f) Realisation of written off bad debts-S 41(1)
g) Dividend income-S 56

5. PERSON –S. 2(31)

The term “person” includes:

a) an individual;
b) a Hindu undivided family (HUF);
c) a company;
d) a firm;
e) an Association of Persons(AoP) or a Body of Individuals,(BoI) 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 with in the four corners of the term “person” and accordingly may be liable to tax.

A brief description of these categories is as follows:

1. Individuals are all living person of blood and flesh like Ram, Shyam, Gopal etc.
2. Hindu joint families are regarded as separate tax entities in view of the specific law of succession prevalent among the Hindus.
3. Company is defined in section 2(31) and includes Indian as well as foreign companies and public as well as private Companies. Besides, the CBDT has the power to declare any institution as a Company. Section 25 companies (charitable companies) are also included under the purview but have separate exemptions under the Act.
4. Partnership firms are regarded as distinct taxable units under the Income Tax. Act. While the partners will be taxed as individuals the firm will be assessed separately as a firm.
5. BOI and AOP are the group of persons carrying on some activities to earn income such as joint venture. Normally AOP may be contractual such as joint venture agreement –if it is not in a firm name or as a company, BOI sometimes may be due to circumstances such as joint owner shop of an estate. Clubs, societies, etc. are also covered under this head.
6. Municipal corporations, Panchayats etc are the examples of Local authorities.
7. Final category is residual category and covers all such persons which are not covered in any of the above six categories.

6. ASSESSEE–S. 2(7)

"Assessee" means a person by whom income tax or any other sum of money is payable under the Act and it includes:

a. 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
b. a person who is assessable in respect of income or loss of another person or who is deemed to be an assessee, or
c. an assessee in default under any provision of the Act

Definition of assessee is also inclusive and may include any other person who as such is not covered by the above three categories. Thus an assessee may be a person himself or his representative such as legal heir, trustee etc. Moreover, importance is given not only to the amount of tax payable but also to the proceedings taken.

Even a minor child would be treated as a separate assessee if his income is generated out of activities performed by him like singing in radio jingles, acting in films, tuition income, delivering newspapers, etc. However, income from investments, capital gains on securities held by a minor child, etc. would be taxable in the hands of the parent having the higher income (mostly the father), unless if such assets have been acquired from the minor's sources of income.

7. ASSESSMENT - S 2(8)

An assessment is the procedure to determine the taxable income of an assessee and the tax payable by him. S. 2(8) of the Income Tax Act, 1961 gives an inclusive definition of assessment "**an assessment includes reassessment**

Normally, an assessee is required to file a self declaration of his income and tax payable by him. This declaration is called as the return of income. (S. 139) the return may be summarily accepted without making any enquiry into the contents of the return. This is called as the 'summary assessment' (143(1). In certain circumstances, the assessing officer may call upon the assessee to explain his return of income and thereafter the assessing officer after making necessary enquiry frames a reasoned order determining the total income and the tax payable by the assessee – S 143(3). This is called the "regular assessment". The assessment is normally final. But in certain exceptional circumstances it can be reopened u/s 147 normally to assess escaped income. This is called the "reassessment'. The definition of assessment includes the regular assessment and reopened or reassessment.

8. INCOME- S 2(24)

Income tax is a tax on income. Still, Income Tax Act does not provide any exhaustive definition of the term "Income" Instead, the term 'income' has been defined in its widest sense by giving an inclusive definition. It includes not only the income in its natural and general sense but also incomes specified in section 2 (24).

Income includes

(i) profits and gains ;

(ii) dividend;

(iii) voluntary contributions received by :

- a trust or an institution created or established wholly or partly for charitable or religious purposes or

- -a scientific research association S.10(21) or
- a fund or trust or institution referred for promotion of sports –S 10(23) or
- any university or other educational institution referred to in sub-clause (iiiad) or sub-clause (vi) or
- any hospital or other institution S 10(23C) (iiiae)/via or
- by an electoral trust or

(iv) Receipts by employees:

- the value of any perquisite or profit in lieu of salary taxable U/s 17(2)/(3)
- any special allowance or benefit, specifically granted to the assessee to meet expenses wholly, necessarily and exclusively for the performance of the duties of an office or employment of profit ;
- any allowance granted to the assessee either to meet his personal expenses at the place where the duties of his office or employment of profit are ordinarily performed by him or at a place where he ordinarily resides or to compensate him for the increased cost of living ;
- the value of any benefit or perquisite, whether convertible into money or not, obtained from a company either by a director or by a person who has a substantial interest in the company, or by a relative of the director or such person, and any sum paid by any such company in respect of any obligation which, but for such payment, would have been payable by the director or other person aforesaid ;

(v) the value of any benefit or perquisite, whether convertible into money or not, obtained by any representative assessee U/s 160 or by any person on whose behalf or for whose benefit any income is receivable by the representative assessee and any sum paid by the representative assessee in respect of any obligation which, but for such payment, would have been payable by the beneficiary;

(vi) Incomes from business – s-28

-Managerial compensation – S. 28(ii) ,

-income derived by a trade, professional or similar association from specific services performed for its members S. 28(iii)

-Export benefits – Duty drawback, cash assistance and DEPB -S. 28(iiia), iiib)and (iiic)

-the value of any benefit or perquisite taxable the value of any benefit or perquisite taxable – S 28 (iv);

-sum received from non-compete agreements - S 28 (va)

-Balancing charge and other receipts earlier allowed as deduction –S 41

-the profits and gains of any business of insurance carried on by a mutual insurance company or by a co-operative society-S-44 any surplus taken to be such profits and gains by virtue of provisions contained in the First Schedule

-the profits and gains of any business of banking (including providing credit facilities) carried on by a co-operative society with its members;

(vi) any capital gains chargeable under section 45;

(vii) any sum earlier allowed as deduction and chargeable to income-tax under Section 59

(viii) any winnings from lotteries, crossword puzzles, races including horse races, card games and other games of any sort or from gambling or betting of any form or nature whatsoever. Including any game

(ix) any contribution received from employees towards any provident fund or superannuation fund or Employees State Insurance Act, 1948 , or any other fund for the welfare of such employees ;

(x) any sum received under a Keyman insurance policy including the sum allocated by way of bonus on such policy.

(xv)any sum of money or value of property received as gift –S 56(2) – [With effect from June. 1, 2010, Shares of closely held companies transferred to another company or firm are covered in the definition of gift except in the case of transfer of such shares for reorganization of business by amalgamation or demerger etc] .

Therefore, income means not only the revenue receipts arising or accruing regularly but also capital receipts like gifts and even donations. On the other hand certain revenue receipts like agricultural income are left out from the scope of the term income.

Some of the principles that have emerged out as a result of customs, practices and judicial pronouncements to ascertain as to what does or does not constitute income are as follows.

1. Revenue receipts are normally regarded as income unless specifically exempted Income is like the fruit of a tree, where tree is the source and fruits are the income.
2. Thus income is normally a regular periodical receipt, received or derived from a certain source and

3. The source of income must be external. No one can earn income by or from himself. Therefore, income accruing to clubs, societies etc from their own members are not taken as taxable income on the ground of mutuality.
4. Income may be in cash or kind.
5. Source of Income may be legal or illegal e.g. bribery, corruption etc.
6. It is the receipt which is regarded as income and not the application or use of the income.
7. Receipts, if diverted at the source are not regarded as income/
8. Any dispute regarding the title of the income does not take away its nature as income.
9. Gifts were considered as capital receipts, and not taxable . However the trend is changed and gifts have been brought under the tax-net as would appear from the following :
   - Gifts made by employer to the employee are taxable u as the salary income of the employee..,
   - Similarly , the personal gifts made by the clients or customers are treated as the business income and
   - All other personal gifts except gifts from close relatives , with certain exceptions like *gift mortis causa* (in contemplation of death) gifts on the occasion of marriage are taxable as income from other sources .(These provisions have been dealt with at their repective places)
10. A distribution of surplus arising from a mutual activity is not considered as income. Thus, a surplus received from a mutual organisation like employees' tea club, or a co-operative housing society will not be the income on the ground of mutuality.
11. Income may be recognised either on receipt basis or on accrual basis depending upon the facts and circumstances of each case and method of accounting applied in that case.
12. Income must be certain. Contingent income is not regarded as income unless and until such contingency occurs and the income arises to the assessee.
13. Income is the sum total of all receipts from all the sources and considered accordingly.
14. Pin money received by a woman for personal expenses or even the savings made by her from such receipts is not considered as income. However the husband will not get any credit from his income for these payments.

15. Income may be received in lump sum or in instalments. Thus, arrears of salary received by a person in lump sum are regarded as his income.
16. Normally only revenue receipts are regarded as income and not the capital receipts unless specifically provided for. For example: Maturity proceeds of Keyman Insurance Policy, sales tax subsidy, Voluntary contribution by a donor to a trust are considered as income though capital in nature.
17. Awards received by a professional sportsperson would be income unless the award is in nature of a gift in personal consideration. Some of the above items are discussed in detail in latter chapters at appropriate places.
18. Even if the business is not of legal nature like smuggling, bribery, hawala business, etc., the income arising out of such business will still be taxable as per heard cases in the Supreme Court/
19. Income of wife is be taxable in the hands of the husband if the assets out of which the income is arising have not been acquired out of the sources of the wife or from an asset gifted by the husband except as consideration for living apart.
20. Income of minor children is be taxable in the hands of the parents having higher income [mother or father] except when the income is arising from the efforts of the minor child say modeling charges.

9. GROSS TOTAL INCOME- S -14:

Section 14 of the Act defines the Gross Total Income as the aggregate of the incomes computed under the five heads after making adjustments for set-off and carry forward of losses. The five heads of income are as follows namely:

1. Income from Salaries
2. Income from House Property
3. Profits and Gains from Business & 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. However, any exemptions as allowed by Section 10 are deducted from the respective heads before arriving at the gross total income like conveyance allowance, capital gains on sale of personal effects, dividend income, etc.

10. TOTAL INCOME:

`The total income of an assessee is computed by deducting from the gross total income all permissible deductions available under the Chapter VI A of the Income Tax Act, 1961. This is also referred to as the "Net Income" or "Taxable Income".

11. SCHEME OF CHARGING INCOME TAX

Income tax is a tax on the total income of an assessee for a particular assessment year. This implies that;

- Income-tax is an annual tax on income
- 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 discussed in Para 4 above.
- Tax rates are fixed by the annual Finance Act and not by the Income-tax Act. For instance, the Finance Act, 2011 fixes tax rates for the assessment year 2012-13.
- Tax is charged on every person if the gross total income exceeds the minimum income chargeable to tax.
- Tax is levied on the "total income" of every assessee computed in accordance with the provisions of the Act.

12. INCOME TAX RATES FOR ASSESSMENT YEAR 2012-13

Income tax rates are prescribed in the Finance Act.. Finance bill is normally called as the budget for that year. After passing of the bill by the two houses of parliament and presidential assent, in becomes the Finance Act. If for any year, the Finance bill can not be passed, tax rates for the preceding rate will continue to be applicable.

Currently, for the assessment year 2012-13, the minimum amount not chargeable to tax is:

- Rs 5,00,000 for super senior citizens
- Rs 2,50,000 for senior citizens ,
- Rs 1,90,000 for women and
- Rs 1, 80,000 for all the other individuals.

Detailed tax rates as applicable to the individual assessees are given below:

MALE INDIVIDUALS (who are nor senior super senior citizens	
Income Slab Rs.	Rate
Upto 1,80,000	NIL
180001-5,00,000	10%
5,00,000 to 8,00,000	Rs.32,000 +20% of the Balance
800001 onwards	Rs 92,000 + 30% of the Balance
SENIOR CITIZENS **(Persons ,who are of the age of 60 years but below the age of 80 years any time during the previous year**	
Upto. 2,50,000	NIL
2,50,001 -5,00,000	10%
5,00,001 to 8,00,000	Rs.25,000 +20% of the Balance
800001 onwards	Rs 85,000 + 30% of the Balance
SENIOR CITIZENS **Persons who are of the age of 80 years and above any time during the previous year**	
Upto Rs. 500000	Nil
500001-800000	20%
800001 and above	Rs. 60000 + 30% on the Balance
D For Women	
Upto 1,90,000	NIL
1,90,000-5,00,000	10%
5,00,000 to 8,00,000	Rs.31,000 +20% of the Balance
800001 onwards	Rs 91,000 + 30% of the Balance

Education Cess:

Tax and surcharge so calculated as reduced by the rebates is subject to educational cess of 2% and secondary and higher education cess of 1% on the total amount of tax payable.

13. SELF ASSESSMENT 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 2012-13 in the case of different assesses?
4. Explain how education Cass will be computed for the assessment year 2012-13? [Ans: 2%+1%]
5. What will be the previous year for X, who starts his business on April 6, 2011[Ans: A.Y. 2012-13]
6. Will the answer to Q 5 be different, if X starts his business on 28th March, 2011? [Ans: A.Y. 2011-12]
7. Every financial year is a previous year as well as an assessment year Discuss.
8. Every financial year can also be an assessment year, Comment
9. Previous year is a financial year immediately preceding the Assessment year Comment
10. What will be the status of University of Mumbai?

    [Ans: Artificial juridical person]
11. Indicate whether the following persons will be taxed as individuals:

    a) X a partner of a firm

    b) Y, a managing director of A Ltd; ”

    c) Z is the member of Z HUF

    d) Municipal Commissioner of Mumbai in respect of the Income of the Municipal Corporation

    e) Municipal Commissioner of Mumbai in respect of his salary from the Municipal Corporation

    f) A minor acting in TV commercials

    [Ans: All except d will be taxed, Firm X , A Ltd , Z HUF , Mun Crpn. Separate tax entities]

2

RESIDENTIAL STATUS

Synopsis

1. Introduction and Objectives
2. Concept of Residential Status
3. Residential Status of Resident Individual
4. Resident and Ordinarily Resident
5. Resident but not Ordinarily Resident
6. Non Resident
7. Illustrations
8. Residential Status of HUF
9. Residential Status of Firm and AOP
10. Residential Status of Company
11. Residential Status of Other Categories
12. Residential Status and Incidence of Tax on Indian & Foreign Income
13. Self Examination Questions

1. INTRODUCTION AND OBJECTIVES

Tax incidence on an assessee depends on his residential status. Residential status is different from the citizenship. Broadly speaking, Indian Income is liable to income tax in all cases whatever may be the residential status or citizenship. It is mainly the foreign income, which may or may not be liable to income tax. The criterion to decide the taxability would be the residential status of an assessee. Thus, 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.

The chapter seeks to explain the concept of residential status and deal with the provisions relating to determination of

residential status of an Individual, a Hindu Undivided Family, a firm and an Association of Persons, a Company and other person. The chapter also deals with residential status and Incidence of tax and meaning of incidental concepts such as receipt and accrual of income in India and income deemed to accrue or arise in India

2. CONCEPT OF RESIDENTIAL STATUS

Section 6 deals with the residential status of the assessee. One has to keep in mind the following norms while deciding the residential status of an assessee:

2.1. 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 company; and
e. Every other person.

2.2. Different residential status –

An assessee may be either:

(a) Resident in India, or

(b) Non-resident in India.

However, a resident individual or a resident Hindu undivided family can either be:

a. resident and ordinarily resident in India; or

b. resident but not ordinarily resident in India; or

Therefore, a resident individual or a resident Hindu undivided family can either be:

a. resident and ordinarily resident in India; or

b. resident but not ordinarily resident in India

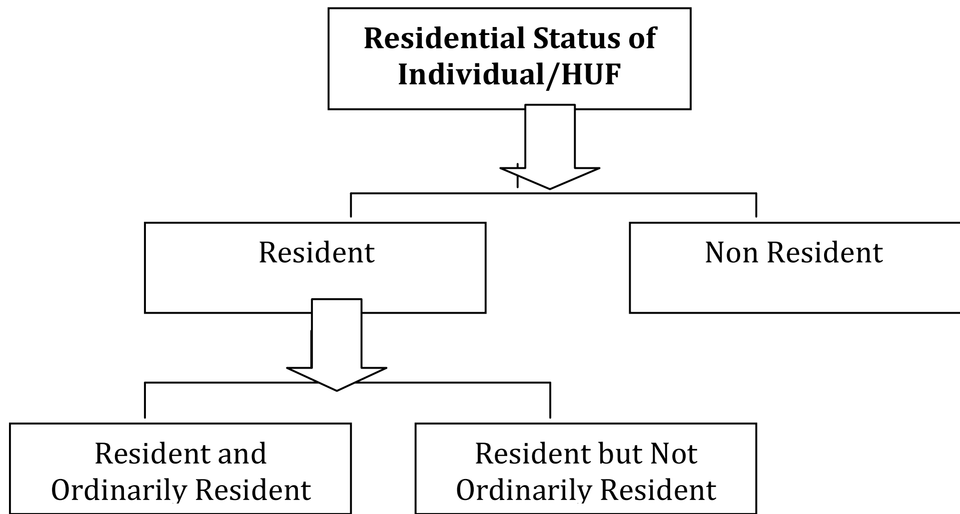
c. non resident

All other assessees (viz., a firm, an association of persons, company and every other person can either be:

a. resident in India; or

b. non-resident in India.

The above can be explained by the following diagram:



2.3. 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.

2.4. 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 one of the conditions of section 6(1). Typical examples of such assessees are cricketers, actors, singers, performers, etc.

2.5. 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. There can be examples of a person being a non-resident in India as well as other countries.

3. RESIDENTIAL STATUS OF AN INDIVIDUAL

As per section 6, an individual may be:

- Resident and ordinarily resident in India,
- Resident but not ordinarily resident in India, or
- Non-resident in India.

Each of this status has an impact on the taxability of income of the assessee. These are dealt with in detail in following paras.

4. RESIDENT AND ORDINARILY RESIDENT;

4.1. 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—

- First find out whether such individual is "resident" in India.
- If such individual is "resident" in India, then find out whether he is "ordinarily resident" in India or Not-ordinarily resident.
- However, if such individual is a "non-resident" in India, then no further action is necessary.

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

1. He is in India in the previous year for a period of 182 days or more OR
2. 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

The Second condition is relaxed in some cases. In those cases an individual needs to be present in India for a minimum of **182 days or more** in order to become resident in India **instead of 60 days** in the followings circumstances, when :

1) **An Indian citizen leaves India** during the previous year for the purpose of taking up employment outside India. OR

2) **An Indian citizen** leaves India during the previous year as a member of the crew of an Indian ship OR.

3) **An Indian citizen or a person of Indian origin** comes on visit to India during the previous year. For this purpose, 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.

4.3 Additional Conditions to Test When a Resident Individual is Ordinarily Resident In India –

Under section 6(6), resident individual is treated as "resident and ordinarily resident" in India if he satisfies the following two additional conditions —

- (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. AND
- (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 both of the two additional conditions [i.e., (i) and (ii).

5. RESIDENT AND NOT ORDINARILY RESIDENT;

As per section 6(1), an individual who satisfies at least one of the basic conditions mentioned above in para 4.2, but does not satisfy both the two additional conditions mentioned above in para 4.3, 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 two circumstances:

One- If he satisfies at least one of the basic conditions but none of the additional conditions and

Two- If he satisfies at least one of the basic conditions and one of the two additional conditions

6. NON RESIDENT

An individual is a non-resident in India if he satisfies none of the basic conditions mentioned above in para 4.2. In the case of non-resident, additional conditions are not relevant.

Summary :

If **both the** basic conditions **not satisfied** –	Non resident
Additional conditions not relevant	
If any one of **the basic** conditions satisfied –	Resident
Proceed further to see if **both of the** additional conditions satisfied –	
If both conditions yes -	Ordinarily resident
Even if one additional condition not satisfied-	Not ordinarily resident

POINTS TO REMEMBER:

1. It is not essential that the stay should be at the same place. It may be at different places
2. It is equally not necessary that the stay should be continuous.
3. Similarly, the place of stay or the purpose of stay is not material. However, if the purpose is for visit to India, the condition of 182 days needs to be satisfied.
4. 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**.
5. Any person in India for 182 days or more will always be a resident of India
6. Any person in India for 59 days or less will always be Non-Resident of India.
7. **While computing the days of stay, remember the years 2000,2004, 2008 and 2012, were leap years.**

7. ILLUSTRATIONS:

1. Rakesh leaves India for the first time on December 20, 2004 during the financial year 2011-12 he came to India once on May 27,2011 for a period of 45 days. Determine his residential status for the assessment year 2012-13.

Solution:

Since Rakesh comes to India only for 45 days in the previous year 2011-12, 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 2012-13.

2. Ravi comes to India, for the first time, on April 16, 2009. During his stay in India, he stays in Delhi up to April 10, 2011 and thereafter remains in Goa till his departure from India on October 2, 2011. Determine his residential status for the assessment year 2012-13.

Solution:

During the previous year 2011-12 Ravi was in India for 185 days from April, 1,2011 to October 2, 2011

Month/2011	April	May	June	July	August	September	October	Total
Days	30	31	30	31	31	30	2	185

He is in India for more than 182 days during the previous year and, thus, he satisfies basic condition (a) consequently, he becomes resident in India u/s 6(1).

To determine that whether Ravi being a resident individual is either ordinarily resident or not ordinarily resident, one has to test whether both the additional conditions as laid down by section 6(6) are satisfied or not.

Additional Condition (i) requires that Ravi should be resident in India in at least 2 years out of 10 years preceding the relevant previous year i.e from the previous year 2001-02 to 2010-11. Ravi is resident in India for the previous years 2009-10 (total stay of 350 days of from April 16, 2009 to March, 31,2010 and 2010-11 [total stay of full 365 days of from April 1, 2010 to March, 31,2011].

Additional condition (ii) requires that Ravi should be in India for at least 730 days during 7 years immediately proceeding the previous year i.e from 2004-05 to 2010-11. Ravi is in India from April 16, 2009 to October,2, 2011. For 715 days i.e. 350 days from April 16, 2009 to March, 31,2010 and 365 days of from April 1, 2010 to March, 31,2011.

Ravi satisfies **one of the basic conditions and only one of the two additional conditions**. Ravi is, therefore, resident but not ordinarily resident in India for the assessment year 2012-13.

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 Ravi stays in Delhi or Goa is irrelevant.

3. Ram, an Indian citizen gets a job in Dubai and leaves India on July, 1, 2011 . Determine his residential status for the assessment year 2012-13

Solution:

During the previous year 2011-12 Ram was in India for 92 days (i.e., April 2011: 30 days; May 2011 31 days; June 2011: 30 days; July 2011: 1 days. Obviously Ram being an Indian citizen, was in India for more than 365 days during the four years preceding the previous year but Ram being a citizen is given the extended time limit of 182 days under basic condition (b] as he leaves India for employment. He does not satisfy any of the two basic conditions, he is a Non-Resident.

4. In illustration 3 above, will the position be any different if Ram leaves India for world tour.

Solution:

In this case Ram would not get the extended time limit of 182 days but the original limit of 60 days; He will be a Resident of India. Since Ram is a natural Indian born citizen, he would obviously be satisfying the two additional conditions laid down in section 6(6), He will be Resident and Ordinarily Resident of India.

5. Chappell, an Australian Citizen comes to India as the Coach of Indian Cricket team. During the previous year 2011 – 12, he stayed in India for 95 days. Before that he was in India for more than 365 days during the 4 years prior to 2011-12,. Will he be a Resident or Non Resident in India?

Solution:

Chappell satisfies the second basic condition of stay of 365 days or more during the four years preceding the previous year 2011-12,, and he was in India for more than 60 days during the financial year. He will be Resident of India. Since he is not a person of Indian origin nor he comes in India on visit, he will not get the extended time limit of 182 days.

8. 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.

8.1. HUF - When 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.

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. In other words, the **residential status of the karta would define the residential status of the HUF.**

8.2. HUF- When Non-Resident

A Hindu undivided family is non-resident in India if control and management of its affairs is **wholly** situated outside India. It follows that if a Karta of A HUF is based outside India, the HUF will be non resident,

8.3. 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 **both of the following two additional conditions** as laid down by section 6(6)(b):

(i) Karta has been resident in India in at least 2 out of 10 previous years according to the basic condition mentioned in Para 4.2 immediately preceding the relevant previous year

(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.

9. RESIDENTIAL STATUS OF FIRMS AND ASSOCIATIONS 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.

10. 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**.

11. 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**.

12. RESIDENTIAL STATUS AND INCIDENCE OF TAX ON INDIAN AND FOREIGN INCOME

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. Thus, in order to understand the relationship between residential status and tax liability, one must understand the meaning of “Indian income” and “foreign income”.

12.1 “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.

12.2 "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 is not deemed to accrue or arise in India.

In brief the income is Indian Income -

- received or deemed to be received in India during the relevant year or
- Whether income accrues or arises or is deemed to accrue or arise) in India during the relevant year

These aspects will be considered in detail in the next chapter.

.

13. SELF ASSESSMENT QUESTIONS:

1. Discuss determination of residential status is important to ascertain the income tax liability?
2. Discuss the legal provisions in respect of residential status of an individual.
3. Briefly state the provisions fro determination of the residential status of an (a) AoP (b) Firm (c) Company.
4. What is meant by the control and management of business?
5. Greg, an Australian citizen, came to India as a commentator during the following period:

From	To	Purpose
10.2. 2011	20-04-2011	World Cup
6-10-2011	25-12-2011	England Tour
04-01-2012	12-01-2012	Miss Universe /Chief Guest
02-03-2012	29-03-2012	Triangular Cup

Ascertain his residential status for the assessment years 2011 – 12 and 2012 – 13 assuming that before the world cup ,his stay in India during the three preceding years was 340 days and 600 days during the seven preceding years

(Ans: 2011-12 Non-Resident, 2012-13 R but NOR)

6. Parthiv an ex-Indian cricketer submits the details of his stay outside India during the following period:

From	To	Purpose/ Place
10.4. 2011	28-04-2011	World Cup /Dhaka
03-05-2011	09-07-2011	England Tour/
27-08-2011	10-09-2011	Canada Tour
11-09-2011	01-10-2011	US holidays
04-01-2012	26-03-2012	Pakistan Tour

Ascertain his residential status for the assessment year 2011-12 assuming that he made his debut in international cricket on 11/03/2012. There he had to be hospitalized for injury. He came out of hospital in U.S. only on 29/03/2012 and he returned to India. Thereafter He went as a coach to Pakistan.
(Ans: Non-Resident)

7. Ashok, an Indian citizen, leaves India on May 22, 2011 for vacation to Uganda and returns on April 9, 2012. Determine the residential status of X for the assessment year 2012-13?
(Ans: Non-Resident)

8. Sheila, 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 2012-13?
(Ans: Non-Resident)

9. Fletcher, a foreign citizen comes to India, for the first time in the last 30 years on March 20, 2011. On September 1, 2011, he leaves India for Nepal on a business trip. He comes back on February 26, 2012. Determine the residential status of X for the assessment year 2012-13.
(Ans> Resident and Not Ordinarily Resident)

Marconi, an Italian citizen, comes to India for the first time on May 28, 2011.
Determine his residential status for the assessment year 2012-13.
(Ans: Resident and Not Ordinarily Resident)

3

INCIDENCE OF TAX

Synopsis

1. Introduction and Objectives
2. Basic Charge of Income Tax
3. Charge of Income Tax
4. Residential Status and Incidence fo Tax on Indian and Foreign Income
5. Incidence of Tax and Scope of Total Income
6. Income deemed to be received in India
7. Income deemed to be accrue or arise in India
8. Receipt vs. Remittance
9. Actual receipt Vs Deemed Receipt Total Income
10. Receipt vs. Accrual
11. Basis of Charge of Dividend Income
12. Illustration
13. Self Examination Questions

1. INTRODUCTION AND OBJECTIVES

We have seen earlier, that the incidence of tax on several factors like the residential status of the assessee, time and place of earning income etc. Residential status is different from the citizenship.

Broadly speaking, Indian Income is liable to income tax in all cases regardless of the residential status or citizenship. Taxability of foreign income would be the residential status of an assessee.

Thus, 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.

The chapter seeks to explain the concept of incidence of tax vis-*à-vis the residential* status and how it affects determination of

residential status of various types of taxpayers -an Individual, a Hindu Undivided Family, a firm and an Association of Persons, a Company and every other person. The chapter also deals with the meaning of important concepts like receipt and accrual of income in India and income deemed to accrue or arise in India

2. BASIS OF CHARGE OF INCOME TAX

Income tax is charged on the incomes of different assesses in the following manner:

- Section 4 is the charging section and specifies the levy of tax on the income of previous year.
- Section 5 defines the scope of total income chargeable to tax depending upon the residential status of the assessee and also the place and time of accrual of such income.
- Section 6 lays down the criteria for determination of residential status of various types of assesses.
- Section 7 specifies the incomes though not received in India but deemed to be received in India.
- Section 8 determines the year of taxability of dividend income
- Section 9 specifies the incomes though not accrued or arisen in India but deemed to accrue or arise in India.

3. CHARGE OF INCOME TAX

Section 4 lays down that income tax is a tax on the total income of the assessee earned during the previous year relevant to the assessment year at the rates specified in the Finance Act. An analysis of the section brings out the following:

a. The charge is on the “total income” of the assessee.
b. The charge of the income tax is on every person called “assessee”
c. The income is computed with reference to previous year relevant to the assessment year subject to certain exceptions such as:
    - Non Resident Shipping Business not having any representative/ office in India (Section 172)
    - Persons leaving India and not likely to return back (Section 173)

- Persons trying to alienate his assets with a view to avoid tax (Section 175)
- Business discontinued during the previous year (Section 176)

In all the above cases, assessment year and previous year are treated the same.

d. Tax payment is mandated during the previous year by way of Tax Deducted at Source (TDS), Tax Collected at Source (TCS) and Advance Tax.

The expressions “person”, “assessee”, “previous year”, “assessment year” and “total income” have been discussed in detail in the preceding chapter.

4. RESIDENTIAL STATUS AND INCIDENCE OF TAX ON INDIAN AND FOREIGN INCOME

Under section 5, incidence of tax on an assessee depends on his residential status and also on the place and time of accrual or receipt of income. Thus in order to understand the relationship between residential status and tax liability, it would be necessary to understand the meaning of “Indian income” and “foreign income”. There is no definition of the term Indian Income. There are certain incomes which apparently appear as the incomes in a foreign country, yet are regarded as the Indian incomes. Provision relating to residential status of an assessee is dealt with in the previous chapter.

4.1. 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.

Simply speaking, the income is Indian Income -

- If it is received or deemed to be received in India during the relevant year or
- It accrues or arises or is deemed to accrue or arise) in India during the relevant year

4.2 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 is not deemed to accrue or arise in India.

5. INCIDENCE OF TAX AND SCOPE OF TOTAL INCOME:

Section 5 defines the scope of total income according to the residential status of the assessee and place and time of the accrual or receipt of income in the following manner:

a. Indian Income taxable in all cases:

Income received in India or deemed to be received in India or income accruing or arising in India or deemed to be accruing or arising in India are included in the income of every assessee regardless of his residential status whether resident or non-resident of R & OR or R & NOR

b. Foreign Income:

Income accruing or arising outside India or deemed to be accruing or arising outside India or income received in India or deemed to be received in India is not included in the total income of a non-resident but included in the total income of a resident and ordinarily resident and a resident but not ordinarily resident if such income is derived from:

- A business controlled in India or
- A profession set up in India

Non-business foreign income will not be included in the income of a person who is resident but not ordinarily resident in India.

The above position can be summarised as follows:

Taxability of income (Section 5)

Resident and Ordinarily Resident [R & OR]	Global Income i.e. Indian or foreign income
Non Resident	Indian Income but not foreign income
Resident and Not Ordinarily Resident [R & NOR]	Indian Income & Foreign income from an Indian controlled business or profession but not foreign non-business income

6. INCOME DEEMED TO BE RECEIVED IN INDIA - S. 7

According to Section 7, the following incomes are included in the scope of total income even if they are not actually received in India:

1. Annual accretion to the credit balance of an employee in the case of recognized provident fund to the extent provided under rules
2. Excess contribution of employer in the case of recognized provident fund to the extent as provided in the rules.
3. Transfer balance to a recognized provident fund from unrecognized provident fund to the extent as provided under the rules.

7. INCOME DEEMED TO ACCRUE OR ARISE IN INDIA - S. 9

Certain incomes are deemed to accrue or arise in India even though they may actually accrue or arise outside India. The categories of incomes under Section 9 that accrue or arise in India are as follows:

1. All incomes accruing or arising whether directly or indirectly through or from
   a) Any business connection in India or
   b) Any property in India or
   c) Any asset or any source of income in India or
   d) The transfer of a capital asset situated in India.

For this purpose the following explanations are relevant:

(i) In case of a business of which all the operations are not carried out in India, only proportionate income of such business as related to the operations carried out in India shall be deemed to accrue or arise in India.

(ii) In case of a non-resident who is purchasing goods in India for the purpose of export, no income shall be deemed to accrue or arise in India to him.

(iii) In case of a non-resident, being a person engaged in the business of running a news agency or of publishing newspapers, magazines or journals, no income shall be deemed to accrue or arise in India to him through or from activities which are confined to the collection of news and views in India.

(iv) In case of:

a) An individual who is not a citizen of India and who is a non-resident or

b) A firm which does not have any partner who is a citizen of India or who is a resident of India or

c) A company which does not have any shareholder who is a citizen of India or who is a resident of India, no income is deemed to accrue or arise in India to such individual, firm or company through or from operations which are confined to the shooting of any cinematograph film in India.

(v) The term “business connection” shall include a person acting on behalf of the non-resident who:

a) in India exercises or has an authority to conclude contract on behalf of the non-resident, unless otherwise his activities are limited to purchase of goods or merchandise for non-resident.

b) has no such authority but maintains stock of goods and merchandise in India, from which he regularly delivers stock or merchandise on behalf of the non-resident.

c) Secures orders in India for the non-resident and other non-resident, controlling, controlled by or subject to the same common control as that of non-resident.

However, the term “business connection” shall not include cases where non-resident carries on a business through a broker, general commission agent or any other agent of independent status, acting in ordinary course of business.

A broker, general commission agent or an agent shall be deemed to be of an independent status if he does not work mainly or wholly on behalf of the non-resident.

2. Income chargeable to tax under the head "salaries" is deemed to accrue or arise in India if it is earned in India. "Salaries" payable for services rendered in India will be regarded as income earned in India which also includes salary paid for the rest period or leave period preceded and succeeded by services rendered in India and forms part of service contract of employment.

3. Salary received by Indian national from the government in respect of services rendered out of India is deemed to accrue or arise in India. However any allowance or any perquisite paid abroad is fully exempt from tax under Section 10(7).

4. Any dividend paid by an Indian company outside India is deemed to accrue or arise in India.

5. Income by way of interest payable by:
   a) The government or
   b) A resident person (excluding interest payable in respect of borrowed funds used for a business or profession carried out of India), or
   c) A non-resident person (where interest is payable in respect of borrowed funds used for the business or profession carried in India) is deemed to accrue or arise in India.

6. Income by way of royalty payable by:
   a) The government or
   b) A resident person (except where royalty is payable in respect of any right of property or services utilised for a business or profession carried out of India for the purpose of earning any income out of India), or
   c) A non-resident person (where royalty is payable in respect of any right of property or services utilised for the purpose of business or profession carried in India or for the purpose of earning any income in India) is deemed to accrue or arise in India.

(i) However, this provision will not apply where the royalties are payable for the transfer of any data, drawings, etc. outside India or imparting of information outside India under an approved agreement by the Central Government made before the 1st day of April, 1976.

(ii) In lump sum, by a resident for transfer of computer software, supplied by a non-resident along with the computer or computer-based equipment under a scheme duly approved by Government of India.

7. Income by way of fees for technical services payable by:

   a) The government or

   b) A resident person (except where the fees are payable in respect of services utilised in a business or profession for earning any income out of India), or

   c) A non-resident person (where such fees are payable for services utilised in a business or profession carried on by him in India or for earning any income from any source in India).

However, this provision will not be applicable if the fees are payable under agreement made before the 1st day of April, 1976 and approved by the Central Government.

It is clarified by way of an that as to provide that the income of a non-resident shall be deemed to accrue or arise in India under the above clauses and shall be included in the total income of the non-resident, whether or not,—

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

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

8. 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.

9. 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 certain incomes which were dealt with earlier. E.g. If a resident holds an immovable property in Delhi and the rent received thereon is transferred to his bank account in Mauritius, the rent would still be subject to income tax though the income has not been received in India.

10. RECEIPT VS. ACCRUAL

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.

11. BASIS OF CHARGE FOR DIVIDEND INCOME - S. 8

Dividend is always declared at the Annual General Meeting and therefore deemed to be an income of the previous year in which it is declared under Section 8. Hence the method of accounting for the dividend becomes immaterial for the purposes of this section.

Interim dividend is deemed to be the income of the previous year in which the amount of such dividend is unconditionally made available by the company to a shareholder. **The date of declaration of interim dividend is not important**. The date on which it is unconditionally made available by a company to a shareholder should be taken into consideration.

Deemed Dividend under S 2(22) is deemed to accrue or arise in the year in which it was paid or distributed.

12. ILLUSTRATION:

Determine the scope of total income in respect of the following incomes if the assessee is a (1) resident or (2) a resident and ordinarily resident or (3) a resident but not ordinarily resident:

	Rs
1. Interest from U.S. Growth Bonds received in India	10,000
2. Interest from U.S. Growth Bonds received in U.S.	60,000
3. Interest from U.S. Growth Bonds received in U.S but remitted to India	60,000
4. Capital gain on house in Mumbai but sold in London	60,000
5. Capital gain on house in Mumbai but sold in Mumbai	60,000
6. Rent of a villa in Paris received in Paris	60,000
7. Rent of a villa in Paris received in Paris	60,000
8. Agricultural Income from Tea Gardens in Sri Lanka received in Sri Lanka	60,000
9. Agricultural Income from Tea Gardens in Sri Lanka received in Mumbai	60,000
10. Profit from a Branch in Sydney	60,000
11. Profit from a branch in Mumbai	60,000
12. Salary for working in Jaipur received in Jaipur	60,000
13. Salary for working in Jaipur received in Lahore	60,000
14. Salary for working in Lahore received in Jaipur	60,000
15. Salary for working in Lahore received in Lahore	60,000

Solution

	Particulars	R&OR Rs.	R&NOR Rs.	N R Rs.
1.	Interest from Uncle Sam Bonds U.S.A. received in India	60,000	60,000	60,000
2.	Interest from Uncle Sam Bonds U.S.A. received in U.S	60,000	---------	----------
3.	Interest from Uncle Sam Bonds U.S.A. received in U.S but remitted to India	60,000	---------	----------
4.	Capital gain on house received in Mumbai but sold in London	60,000	60,000	60,000
5.	Capital gain on house received in Mumbai but sold in Mumbai	60,000	60,000	60,000
6.	Rent of a villa in Paris received in Paris	60,000	--------	---------
7.	Rent of a villa in Paris received in Mumbai	60,000	60,000	60,000
8.	Agricultural Income from Tea Gardens in Sri Lanka received in Sri Lanka	60,000	--------	---------
9.	Agricultural Income from Tea Gardens in Sri Lanka received in Mumbai	60,000	60,000	60,000
10.	Profit from a Branch in Sydney	60,000	60,000*	------
11.	Profit from a branch in Mumbai	60,000	60,000	60,000
12.	Salary for working in Jaipur received in Jaipur	60,000	60,000	60,000
13.	Salary for working in Jaipur received in Lahore	60,000	60,000	60,000
14.	Salary for working in Lahore received in Jaipur	60,000	60,000	60,000
15.	Salary for working in Lahore received in Lahore	60,000	60,000	60,000
	Total	**9,00,000**	**6,60,000**	**6,00,000**

*if controlled from India

13. SELF ASSESSMENT QUESTIONS

10. When the income is deemed to accrue or arise or be received in India?
11. The incidence of income-tax depends upon the residential status of an assessee". Discuss.

12. Determine whether the following is true or false:
    I. The business income received by X Ltd. an Indian company in New York is foreign income of X.
    II. The dividend received from a foreign company in India is Indian Income

13. 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

14. Determine the scope of total income in respect of the following incomes if the assessee is a (1) resident or (2) a resident and ordinarily resident or (3) a resident but not ordinarily resident

New York business income controlled from India	Rs. 100000
Mumbai Business Controlled from Paris	Rs. 40000
Salary in New York as Indian ambassador	Rs. 90000
Profit on sale of shop in Kolkata paid in Karachi	Rs. 50000
Acting in Indian film –fee received in Rome	Rs. 70000
Past untaxed profits remitted to India from London	Rs. 120000

(Ans. Resident 350000, R & OR 250000, R& NOR 350000/ past profits not taxable)

15. Blair, a French Citizen had the following incomes during the year ended 31/3/2012. Compute his Total Income for Asst. Year 2012-13 if he is a (1) resident or (2) a resident and ordinarily resident or (3) a resident but not ordinarily resident.

Income from House property in India	Rs. 30000
Income from property in Rome	Rs. 20000
Interest from Bank account in India	Rs. 2400
Income from business in Bangladesh controlled from India	Rs. 32000
Interest from Bank account in U.S.	Rs. 22000
Salary earned and received in Tokyo	Rs. 24000
Income earned and received in London	Rs. 26000
Dividend from British Company received in India	Rs. 34000

(Ans. Resident 19400, R&OR Rs. 98600 R but NOR Rs 66400)

7. Following are the particulars of income of X for the previous year 2011-12:

    a. X is employed in India and receives Rs. 24,000 as salary.

    b. Dividend received in London on June 3, 2011: Rs. 31,000 from a foreign company;

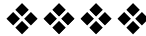
    c. Share of profit received in London on December 15, 2011 from a business situated in Sri Lanka but controlled from India:

    d. Rs. 60,000; remittance from London on January 15, 2012 out of past untaxed profit of 2003-04 earned and received there: Rs. 30,000 and interest earned and received in India on May 11, 2012 Rs. 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 2012-13

Ans: (R& OR , his gross total income will be Rs. 150000i.e. Rs. 24,000 + Rs. 31,000 + Rs. 60,000 R& N OR Rs. 84,000 i.e., Rs. 24,000 + Rs. 60,000). non-resident, Rs.24,000.

The remittance from London of Rs. 30,000 is not taxable it is not "receipt" of income. The interest of Rs. 76,000 earned and received in India is taxable 2012-13.)



4

INCOME EXEMPT FROM TAX

Synopsis:

1. Introduction and Objectives
2. Income exempt under section 10
   - 2.1 Agricultural income
   - 2.2 Receipts by a member from a Hindu Undivided Family
   - 2.3 Share of profit from partnership firm
   - 2.4 Educational scholarships
   - 2.5 Income of minor Child
   - 2.6 Other Exemptions
3. Self Assessment questions

1. INTRODUCTION & OBJECTIVES:

Generally speaking, every receipt is taxable as income under the income tax law unless it is specifically exempted. Income may be received in cash or in kind. It may be capital or revenue in nature. Further, burden is on the assessee to prove that any receipt is exempt from income tax .

The exemption may claim three ways.

- Firstly, S. 10 to 13 deal with separate treatment of certain receipts, which are to be excluded from total income.
- Secondly, exemptions are also provided in S. 15 to 56. These sections deal with the computation of total income under five different heads viz Salaries, Income from house property, Profits and gains of business & profession, capital gains and Income from other sources. These exemptions are provided in connection with the computation of income under a particular head. These provisions are dealt with at their respective places.
- Finally, certain receipts may be claimed as exempt as capital receipts or receipts not falling under the definition of income.

The chapter deals with the incomes which are exempt from tax. Such incomes are not considered at all for the purposes of computation of total income. The exemptions are different from deductions. While deductions are available after computation of gross total income, exemptions are not included in gross total income.

2. INCOME EXEMPT UNDER SECTION 10:

Section 10 specifies the classes of incomes which are absolutely exempt from tax. Such exempted incomes do not form part of total income and are accordingly ignored from the computation of gross total income. It must; however be noted that the burden of proving that a particular item of income falls within this section is on the assessee. Some of such incomes are discussed in the paras to follow hereafter.

2.1. Agricultural Income – S 10(1):

Under the constitution of India, agriculture is in the state list and the Central Government is not constitutionally competent to levy taxes on agriculture. Accordingly, under Section 10(1) of the Income Tax, Act, 1961, agricultural income is exempt from tax.

However, if net agricultural income of an assessee exceeds Rs 5,000, then such agricultural income is taken into consideration for rate purposes to find out tax on non-agricultural income. As a result, in such cases, non- agricultural incomes are subjected to tax at a higher rate.

S. 2(1A) defines Agricultural income" as any income derived from land which is used for agricultural purposes and which is assessed to land revenue in India. Such income must satisfy the following three conditions:

a) Rent or revenue should be derived from land.
b) The land must be used for agricultural purposes.
c) The land should be situated in India.

The following are some examples of incomes which are not agricultural incomes:

1. Dividend from company engaged in agricultural activities.
2. Income from forest trees of spontaneous growth.
3. Income from stone quarries.
4. Royalty income of mines, etc.

The exemption is only in respect agricultural income received in India. Agricultural income from a foreign country is treated as non-agricultural income in India.

Illustration 1

If Anish has agricultural land in Nashik but sub-lets it to a tenant for use. Anish pays the tenant a monthly salary and the sale proceeds of the agricultural produce are sent to Anish.

(1) Whether Anish would be liable to tax

(2) Whether the tenant would be liable to tax

Solution

(1) The sale of agricultural produce would be treated as agricultural income since the revenue is derived from land in India which was used for agricultural purpose.

(2) The salary received by the tenant does not satisfy the conditions to be classified as agricultural income. Therefore it would be taxed under the head "Income from Salaries" if it exceeds the minimum amount chargeable to tax.

2.2. Receipts by a member from a Hindu Undivided Family (HUF)-S.10(2)

HUF is a separate entity for tax purposes. It is liable independently to pay tax on its income. Obviously, no tax should be levied on distribution of the income of HUF among its members as it will amount to taxing the same income twice. Accordingly, 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 impartible estate belonging to the family is exempt from tax under section 10(2) and is not included in the total income of the individual. This is however, subject to the provisions of S 64(2), which provides for clubbing of income of HUF in the hands of member if same is derived from the property thrown in family hotchpot by such member.

Illustration 2

X, an individual, has personal income of Rs. 5,00,000 for the previous year 2011-12. He is also a member of a Hindu undivided family, which has an income of Rs. 2,50,000 for the previous year 2011-12. Out of income of the family, X gets Rs. 1,25,000, as his. Show the status of the income from taxability point of view.

Solution:

X is liable to pay tax only on his personal income of Rs. 5,00,000. His share of Rs. 1,25,000 from HUF is exempt in the hands of X under section 10(2) irrespective of the fact whether the family is chargeable to tax or not . The HUF is liable to tax in respect of its income of Rs,2,50,000

2.3. Partners ' share of profit from partnership firm-S10(2A)

Like a HUF, a firm is also a separate entity for tax purposes liable to be taxed on its income. To avoid double taxation of the income, firstly in the hands of the firm and then in the hands of the partners, section 10(2A), provides for exemption of share of profit received by partners from a firm. However, any remuneration paid by the firm or any interest on capital shall not form part of the share of profit received by partner and will be taxed in the hands of the partners. Any remuneration or interest on capital in excess of the limits laid down in Section 40 shall be chargeable to tax in the assessment of the firm and will form the part of the income allocated to partners exempt U/s 10(2A).

2.4. Educational scholarships-S.10(16):

Under section 10(16), any scholarship granted to meet the cost of education is exempt from tax. Following points should be noted in this regard:

1. Object of the scholarship must be to meet the cost of education.
2. The cost of education includes not only the fees but also other expenses connected with the education.
3. It is not necessary that the Government should finance scholarship. It may be from a non- governmental agency or a private party as well.
4. Scholarship given to an employee will also be eligible to exemption u/s 10(16).
5. The law does not specify the type of education. Therefore any course will be eligible for this purpose.

2.5. Income of minor child-S10(32):

Under section 10(32), where 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 Rs. 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 Rs. 1,500, the aforesaid exemption shall be restricted to the income so included in the total income of the individual.

Illustration 3

Determine the amount exempted U/s 10(32) if:

1) Income of X, an individual includes his minor son Y's income of Rs. 1000.

2) Suppose the income of Y includible in the income of X is Rs. 25000.

Solution

1) Exemption u/s 10 (32) will be Rs. 1000 only
2) Maximum exemption u/s 10 (32) will be Rs. 1500 only.

Illustration 4:

Akhil and Bharat's incomes of Rs 7,500 and Rs 5,500 were clubbed with the income of their father Abhar. Calculate the exemption available to Abhar in respect of the income of minor children.

Solution

The exemption of Rs 1,500 is available per child. Therefore Abhar is eligible to get an exemption of Rs 3,000 in respect of the incomes of Akhil and Bharat clubbed with his income.

2.6. Other Exemptions:

Sec. 10 provides a comprehensive list of exempt incomes. Some of the important exemptions e.g. gratuity, pension etc are relevant while computing income under the five heads of income. These exemptions are incorporated in the chapters dealing with computation of income. Other exemptions are listed below.

a. Exemption to foreigners/ Non Residents.

- Interest income of non-resident from notified securities, saving certificates/ NRE Account is exempt u/s 10(4) These exemptions are conditional and applicable mainly to persons of Indian origin purchasing the securities in convertible foreign exchange.
- Remuneration of foreign diplomats is exempt u/s 10(6).
- Remuneration of a Trainee of a Foreign Government is exempt u/s 10(6)(xi),
- Remuneration received by Foreign National as an Employee of Foreign Enterprise is exempt u/s 10(6)(vi)
- Salary of Non-Resident Employee of a Foreign Ship is Under Section 10(6)(viii)

b. Exemption to salaried employees

- Several sections provide for exemption to salaried employees such as leave Travel Allowance, House Rent allowance, Gratuity, Retrenchment allowance, Commuted

pension, special allowances etc. and dealt with in the chapter relating to salaries.

- Certain other incomes of Non-Resident deriving income other then salary, royalty or fees for technical services from Government or an Indian concern under an approved agreement are exempt under Section 10(6B) and if their tax liability is paid by the employer the tax so paid is exempt from tax.
- Foreign allowances and perquisites to Government employees outside India under Section 10(7),
- Income of an Employee by way of remuneration or social security tax or otherwise of a Foreign Government under Co-operative Technical Assistance Programme/ projects is exempt under Section 10(8)
- Income of a Consultant by way of remuneration or, social security tax or otherwise under a Technical Assistance Grant Agreement between the International Organisation and the Government of Foreign State is exempt under Section 10(8A) in the case of a consultant the following incomes shall be exempt from tax:
- Income of any other person, being a non-resident, engaged by the agency for rendering technical services in India in connection with any technical assistance programme or project, provided in accordance with an approved agreement
- Income of an Individual who is assigned to duties in India in connection with any Technical Assistance Programme and Project in accordance with an Agreement entered into by the Central Government and the Agency are also exempt under this clause.
- In case of an individual who is assigned to duties in India in connection with any technical assistance programme and project in accordance with the agreement entered into by the Central Government and the Agency, the remuneration received by him directly or indirectly, for such duties from any consultant referred to in clause (8A), income shall be exempt from tax under Section 10(8B)
- Under Section 10(9) the exemption is granted to any member of the family as referred in sub-section 8, 8A and 8B of Section 10 discussed in preceding para hereinbefore. The exemption is in respect of the income which accrues or arises outside India, in respect of which such member is required to pay any income tax or social security tax to the Government of that foreign state.
- Under section 10(5), 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 is exempt. 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.

- Under 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.
- Under 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.

c. Exemptions to Institutions / Funds :

The income of the following institutions is exempt subject to certain conditions:

1) Local authority i.e. a panchayat, municipality, municipal committee, district board or cantonment board. S. 10(20)
2) Approved Notified scientific and research association applying which has as its object, undertaking research in social science or statistical research, and applying its income wholly and exclusively to its objects, including profits and gains of a business carried on by an institution which is incidental to its objects. S. 10(21)
3) News agency set up in India which applies its income or accumulates it for application solely for collection and distribution of news and does not distribute its income in any manner to its members. S. 10(22B)
4) Regimental Fund or non-public fund. S. 10(23AA)
5) Approved fund for the welfare of employees. S. 10(23AAA)
6) Pension fund (Jeevan Suraksha) set up by the Life Insurance Corporation of India or a pension fund of any other insurance company. S. 10(23AAB)
7) Public charitable Trusts S. 11
8) Khadi and Village industries Board. S. 10(23B)
9) Religious Institutions.
10) European Economic Community.
11) SAARC Fund for Regional Projects.

12) ASOSAI-Secretariat
13) Insurance Regulatory and Development Authority
14) Prime Minister's Relief Fund
15) National Foundation for Communal Harmony
16) University/educational institution, hospital or medical institution 10 (22)/(22A)
17) Professional bodies. S. 10(23A)
18) Notified fund, charitable/ religious institution or trust. S. 10(22B)
19) Mutual fund. S. 10(22B)
20) Notified Investor Protection Fund set up by recognised Stock Exchanges
21) Credit Guarantee Fund Trust for Small Industries
22) Approved Venture Capital Fund or Venture Capital Company
23) Trade Union or Association of trade Unions from house property and other sources. S. 10(24)
24) Statutory Provident Fund under Provident Fund Act. S. 10(25)
25) Employees' State Insurance Fund set up under the Employees' State Insurance Act. S. 10(25A)
26) Members of scheduled tribes residing in specified areas. S. 10(26)
27) Statutory Corporation, body, association or institution formed or established for promoting the interests of the members of Scheduled Castes/ Schedules Tribes or backward classes or of any two or all of them. S. 10(26B)
28) Corporation established by the Central/ State Government for promoting the interests of a notified minority community. S. 10(26BB)
29) Ex-Servicemen Corporation established under an Act for the welfare and economic upliftment of ex-servicemen being the citizens of India. 10(26BBB)
30) Co-operative Society formed for promoting the interest of members of either the Scheduled Caste or Scheduled Tribes. S. 10(27)
31) Coffee Board, Rubber Board, Tea Board, Tobacco Board, Marine Products Export Development Authority, Agricultural and Processed Food Products Export Development Authority and Spice Board. S. 10(29A)

32) Subsidy received from the Tea Board for replantation or replacement of tea bushes or for rejuvenation or consolidation of areas used for cultivation of tea under any scheme notified by the Central Government. S. 10(30)

33) Subsidy received from the Rubber Board, Coffee Board, Spices Board or any other Board under any scheme of replanting or replacement, etc. S. 10(31)

34) Daily allowance of Members of Parliament while the parliament is in session is and Members of State Legislative Assemblies (upto Rs. 2000) exempt u/s 10(17)

d. Capital Gains

- Any long-term capital gain arising on transfer of eligible equity shares of a company acquired on or after 1.3.2003 but before 1.3.2004 and held for 12 months or more.
- Any capital gain arising to an individual/ HUF on compulsory acquisition of an agricultural land in urban areas (situated within the jurisdiction of a municipality or a cantonment board having population of 10,000 or more or within 8 kms from the local limits of such municipality/ board), where the compensation/ consideration is received by the assessee on or after 1.4.2004. Provided, the land was being used for agricultural purposes by the HUF/ individual or his parent(s), during the period of 2 years immediately before acquisition.
- Any long-term capital gains from transfer of equity shares of a company or units of an equity-oriented fund on or after 1.10.2004 and subject to Securities Transaction Tax is exempt u/s 10(38).
- Under section 10(33), any income arising from the transfer of a US 64 is not chargeable to tax. However, 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.

e. Miscellaneous

- 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. Except in case of the death of the person and 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, which shall not be taken into account for the purpose of calculating the actual capital sum assured under this clause.

- Under section 10(19), family pension received by the widow or children or nominated heirs of a member of the armed forces or paramilitary 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.

- 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 or any income in respect of units of mutual fund; UTI [, from the administrator units from the specified company is exempt under section 10(34)/ (35).

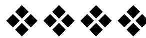
- U/s 10AA export incomes of undertakings in SEZ are exempt on pro rata basis i.e

$$\frac{\text{Business Profit X Export Turnover}}{\text{Total Turnover}}$$

- Incomes of charitable trusts and political parties are also exempt from tax subject to the provisions of S 11,12 and 13.

3. SELF-ASSESSMENT QUESTIONS:

1) Name three items of income which are exempt from under Section 10 and explain briefly any two of them.
2) What is the difference between deduction and exemption? Give 3 examples of each.
3) Manan gets Rs 8,000 by letting out his agricultural land to a tenant who used the land for vermiculture. Clarify if Manan would be eligible for exemption for agricultural income with appropriate reasons.
4) What are the exemptions available to foreign nationals in India?
5) Describe any 8 exemptions under Section 10 of the Income Tax Act, 1961.
6) Write short notes on:
    a) Gratuity
    b) Leave Salary
    c) Retrenchment Compensation
    d) House Rent Allowance
    e) Dividends
    f) Income of a minor child



5

HEADS OF INCOME

Synopsis

1. Introduction and Objectives
2. Classification of incomes
3. Importance of different heads
4. Heads to be mutually exclusive
5. Tax on aggregate income under all the heads
6. Common residential status for all the heads
7. Separate sources of income under one head.
8. Expenses under each head of income
9. Expenditure incurred in relation to income not includible in total income
10. Self Assessment Questions

1. INTRODUCTION & OBJECTIVES

Income tax is payable by an assessee on his total income from all the source of income. Each source has its own unique features and requires specific treatment for correct computation of income from that particular source. Naturally, rules and method for computation of income from each such source are different according to the nature of the source.

After determination of the residential status of the assessee and the scope of taxable income, this chapter deals with the important aspect of classification of income under various heads of income other incidental matters.

2. CLASSIFICATION OF INCOMES

Section 14 of the Income Tax Act, 1961 deals with the classification of income under five heads of income. . The five heads of income listed in S 14 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)

3. IMPORTANCE OF DIFFERENT HEADS

S. 4, 5 and 6 lay down the framework for levy of income tax . Section 4 defines the basis of charge. Section 5 defines the scope of total income according to the residential status of a person determined u/s 6 and the place where the income accrues or arises or received. S 7, 8, 9 deal with provisions relating to Income deemed to be received, dividend income and income deemed to accrue or arise in India respectively.

Section 10 to 13 deals with exclusion or exemption of certain incomes discussed in detail in a separate chapter. Sum total of these provisions is that they lay down the basic scheme of the income tax as to what is to be included and what is to be excluded from the total income.

Section 14 deals with the classification of income under various heads according to the nature of the sources and lays down the foundation for the principal provisions viz. s. 15 to 59 of the Income Tax Act dealing with the machinery provisions for computation of income under various heads after allowing deduction and after deeming various items as deemed incomes under each of these heads.

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”. Moreover, 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. HEADS TO BE MUTUALLY EXCLUSIVE

All the heads of income are mutually exclusive. If any income is considered under a particular head e.g. Income from

house property, it will not be taken into consideration for another head e.g. Profits and Gains from business and profession.

The nature of income is such that at times, it may not be possible to have water-tight compartmentalization.

Illustration 1

3 offices are compositely let out on rent by Swayam alongwith services like intercom, security guard, telephone connection, furniture and fixtures, etc. Under which head would the income be taxable?

Solution

The rent in respect of the commercial property should be taxed under “Income from House Property”. However, income arising out of rentals of the other services should be taxable under the head “Income from Other Sources”. Alternatively, the entire income arising out of the property as well as the services could be taxable as “Income from Business or Profession”

As per departmental clarification, the income in respect of properties should be taxed as “Income from House Property” and the income out of rentals of the other services to be taxed under “Income from Other Sources”.

5. TAX ON AGGREGATE INCOME UNDER ALL THE HEADS

Although the income is computed under five different heads of income, tax will be computed on the aggregate or total income from all the sources taken together at the prescribed rates. However, different tax treatment is given to different items. For instance, Long term Capital gains (LTCG) are generally taxed at 20%. But LTCG on listed securities is exempt from tax. Similarly, short term capital gain on sale of equity shares is taxed at 15%. The amount of such short term capital gains would be deducted from the aggregate total income and accordingly tax rates are applied. Similarly, shipping companies are taxed on the basis of tonnage of the shipping fleet. Lotteries , horse races etc are taxed at the maximum rate of tax @ 30% All such incomes are excluded and tax is computed on rest of the total income.

6. COMMON RESIDENTIAL STATUS FOR ALL THE HEADS

S. 6 provides that where a person is resident for the purpose of any particular head of income, he will also be considered as resident for the purposes of computation of income under all the heads of income.

7. SEPARATE SOURCES OF INCOME UNDER ONE HEAD.

Income is classified for each head of income. That head of income may have different sources of income falling under that head. For instance a person may be in receipt of his salary from more than one employer or rent from two or more house properties or more than one business. All such sources will be clubbed together to arrive at the income from that head.

.

8. EXPENSES UNDER EACH HEAD OF INCOME

It may be noted that expenses may be allowed under each head of income according to the provisions applicable. The recent trend Is to restrict and standardize the allowance of expenditure. For instance virtually no expenses except professional tax are allowed under the head salaries. Capital gains envisage deduction if only the cost of acquisition and improvement and transfer expenses and so on and so forth.

9. EXPENDITURE INCURRED IN RELATION TO INCOME NOT INCLUDIBLE IN TOTAL INCOME

Section 14 A provides that no deduction shall be allowed in respect of expenditure incurred by the assessee in relation to exempted income that is the income which does not form part of the total income under this Act

10. SELF ASSESSMENT QUESTIONS :

1. Enumerate various heads of income under the Income Tax Act, 1961.
2. State with reason that can a Income be computed under two heads of income.
3. How are the different heads mutually exclusive?
4. Would expenses in respect of collection of dividend be deductible fro income from other sources?

6

SALARIES
(Sections 15, 16 & 17)

Synopsis

1. Introduction and Objectives
2. Basis of Charge
3. Meaning and essential characteristics of salaries
4. Scope of salary income
5. Tax Treatment of some receipts
   5.1. Basic Salary
   5.2. Fees, Commission and Bonus
   5.3. Arrears of Salaries
   5.4. Advance salary
   5.5. Gratuity S. 10(10)
   5.6.. Commuted Pension (S. 10(10A) :
   5.7. Leave Salary or Encashment of Leave Salary:{S. 10(10AA)}
   5.8. Retrenchment compensation –S.10 (10B)
   5.9. House Rent Allowance (S. 10-13A)
   5.10. Pension to Gallantry award winners (S.10 (18)
6. Taxable Value of Cash Allowances
   6.1. Entertainment Allowance S 16(ii)
   6.2. Dearness Allowance S (15 & 17)
   6.3. City Compensatory Allowance
   6.4. Non-Practicing Allowance
   6.5. Warden/Proctor Allowance
   6.6. Deputation Allowance
   6.6. Overtime Allowance
   6.8. Fixed Medical Allowance
   6.9. Servant Allowance
   6.10. Tiffin /Lunch Allowance
   6.11. Transport Allowance
   6.12. Education Allowance
   6.13. Out of station Allowance

6.14. Foreign allowances
6.15. Allowances to judges
6.16. Allowances by UNO
6.17 Other Allowances
7. Taxable Value of Perquisites
8. Classification of Perquisites
9. Valuation of Perquisites
10. Profits in lieu of Salary
11. Deductions
11.1 Entertainment Allowance
11.2 Profession Tax
12. Practical illustrations
13. Self Assessment Questions

1. INTRODUCTION AND OBJECTIVES:

Among the five heads of income listed by S.14, " Salaries" is the first and most important head of income . The concept of "Salaries" is very wide and includes not only the salary in common parlance but also various other receipts, gifts, perquisites and benefits.

The lesson is divided into various sections dealing with the concept of salary income and its characteristics, which define as to what constitutes "salaries" followed by the incomes falling under this head the computation of basic salary, types of allowances and perquisites, valuation of the perquisites, various income tax provisions for computing taxable value of allowances etc and their detailed descriptions along with the applicable legal provisions of income tax.

2. BASIS OF CHARGE

Section 15, 16 and 17 are concerned with the computation of "salaries". To begin with , Section 15 explains the basis of charge of salaries , which in turn is defined in Section 17. Section 16 prescribes the deductions to be made while computing the income from salary. As per Section 15 salary consists of:

- any salary due from an employer or a former employer to an assessee in the previous year whether actually paid or not,
- any salary paid or allowed to him in the previous year by an employer or former employer to an assessee in the previous year whether actually paid or not, and

- any arrears of salary paid or allowed to him in the previous year by an employer or a former employer if not charged to income tax for any earlier previous year.

3. MEANING AND ESSENTIAL CHARACTERISTICS OF SALARIES:

Salary, in simple words, means remuneration of a person in any form, which he has received from his employer for rendering personal services to him under an expressed or implied contract of employment or service.

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.

This implies the presence of the following norms or essential characteristics to determine whether any particular income is to be taxed under the head ''Salaries'' or not.

a. Employer-Employee Relationship :

There must be **r**elation of employer and employee between the payer of income and receiver of income. Remuneration received in any other capacity will not be treated as salary. Thus for instance , salary of a Member of Parliament cannot be specified as salary, since it is received from Government of India which is not his employer.

b. Compensation for services rendered :

The payment must be made to an employee by the employer as compensation for the services rendered by the employee. However, payment made in other forms like gift, perquisites are also included in the definition of the term "salary''

c. Name not important:

Salary may be called as such by whatever name. There is no difference between salary and wages so long as the relationship between the payer and payee is that of employer and employee and the payment is made as a compensation for the services rendered by the employee.

d. More than One Sources :

Salary may be from more than one employer.

e. Type of Employment:

Salary may be in any capacity like part-time employment or full time employment.

f. Past, Present and prospective employer

Salary may be received from not just the present employer but also a prospective employer and in some cases even from a former employer for example pension received from a former employer.

g. Real intention to pay :

Salary income must be real and not fictitious. There must exist an intention/ obligation to pay and `receive salary.

h. Subsequent Surrender of Salary not tax-free;

Salary is taxed on due basis. A subsequent surrender of the salary will not be tax-free except where an employee surrenders his salary to the central government, and then the salary so surrendered will not be treated as taxable income of the employee.

i. Tax- Free salary

Salary paid tax free is also taxable in the hands of the employee, though contractually income tax on such is borne not by the employee but by the employer.

j. Time of taxability;

Salary is taxable in the year of **receipt** or in the year of earning or **accrual** of the salary income, whichever is **earlier**. In other words advance salary will be taxed when received and unpaid salary will be taxed on accrual i.e. if the salary has been received first, then it will be taxable in the year of receipt. If it has been earned first but not yet received then it will be taxable in the year of earning. However, salary once taxed shall not be subjected to tax again .Accordingly accounting method employed by the employee is not relevant to determine the taxability of salary.

k. Salary received by individuals only

Salary is a compensation for personalised services, which can obviously be rendered by a normal human being and not a body corporate. Salary income is taxable in the hands of individuals only. No other type of person such as a firm or HUF, companies can earn salary income.

l. Voluntary payments taxable as salary

Voluntary payments like gift etc also form the part of taxable salary.

m. Salary in respect of services rendered in India

Salary, leave salary and pension even if paid outside India are deemed u/s 9 to accrue and arise in India and are taxable in

India. Further, Salary paid to Indian diplomats by the Government of India is deemed to accrue and arise in India although the same is exempted e u/s 10.

n. Gross salary Taxable;

Compulsory deductions 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. SCOPE OF SALARY INCOME

4.1. Section 15 defines the Scope of salary income and section 17 defines it. Section 17 gives an inclusive definition of salary. Broadly, it includes:

a. Wages;
b. Any Pension or Annuity;
c. Any Gratuity;
d. Any fees, commission, perquisites or profits in lieu of or in addition to salary or wages;
e. Any advance of salary;
f. Any encashment of leave salary;
g. Annual accreditation to provident fund above the prescribed limits; and
h. Any amount of credit to provident fund of employee to the extent it is taxable.

4.2. The term "salary" includes not only the basic salary but also Fees, Commission and Bonus, taxable value of cash allowances and perquisites, Retirement Benefits, encashment of leave salary, advance of salary, arrears of salary, various allowances such as dearness allowance, entertainment allowance, house rent allowance, conveyance allowance and also includes perquisites by way of free housing, free car, free schooling for children of employees, etc. Tax treatment of all such receipts is given in the following paras.

5. TAX TREATMENT OF CERTAIN RECEIPTS:

5.1. 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, 2010 in the grade of 12000 –300 – 15000, this means that he will start at a

basic salary of Rs.12000 from 1st May, 2010. He will get an annual increment of Rs.300 w.e.f. 1st May, 2011 and onwards every year on the same date till his basic salary reaches Rs. 15,000. No further increment is given thereafter till next date of increment or the date when he is promoted and placed in other grade. .

5.2. 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 discussed later

5.3. Arrears of salary:

Arrears of salary are taxed on receipt basis, if the same has not been taxed earlier. However, relief u/s 89 will be allowed in respect of such arrears.

5.4 Advance Salary:

Advance Salary is taxable on receipt basis in the year of receipt; however there will be no tax in the year of actual accrual of such salary again. Further assessee shall be entitled to relief u/s 89 in respect of advance salary. However, **loan to employee is not treated as advance of salary and** the same is not taxable.

5.5. Gratuity (Section 10(10):

Gratuity is the lump-sum payment made by the employer to the employee on his retirement or termination. S. 10 gives the manner of treatment of gratuity, which is summarised as follows:-

- **In case of employees of Central or State Government any local authority,** the total gratuity received on termination as per service rules will be **exempt**.
- In case of other employees where the Payment **of Gratuity Act is applicable**, from the total gratuity received on termination, the least of the following will be exempt:-
    - I. Rs. 350000
    - II Amount of gratuity actually received.
    - III **15 days' salary** based on salary **last drawn** for every completed year of service or part thereof in excess of 6 months. While calculating the average salaries denominator will be taken as **26 days NOT 30 days**

- In case of other employees where the Payment of **Gratuity Act is not applicable**, from the total gratuity received on termination, the least of the following will be exempt:-
    - I. Rs. 350000
    - II. Amount of gratuity actually received.
    - III. **half month's salary** for every completed year of Service ignoring the fraction based on **average of the salary of 10 months'** preceding the month of retirement year of service or part thereof in excess of 6 months.

ILLUSTRATION-1.

After rendering services for 22 years and 9 months, A retires from his service on 1st June, 2011. He was drawing a basic Salary for 10 months preceding the month of his retirement at Rs 20,000 p.m. He received gratuity amounting to Rs. 5,00,000

Determine the amount of exemption of encashment of leave salary if his employer is:-

a) The State of Maharashtra or

b) XYZ Limited,,covered under the Payment of Gratuity Act,1972

c) ABC Limited Ltd., not covered under the Payment of Gratuity Act,1972

Solution:

a) Since A is a government employee**,** amount received as gratuity on retirement is fully exempt.

b) A is the employee of a private employer XYZ Limited covered under the Payment of Gratuity Act, 1972.

Exempt amount will be the least of the following:

I.	Actual amount received	Rs 5,00,000
II.	Notified amount	Rs 3,50,000
III	15 day's salary based on last drawn salary	
	Rs.20,000 * 15/26 *23 years	Rs 2,65,385

Gratuity of Rs. 265385 will be exempt and the balance of Rs. 2,34,615 will be taxable.

c) A is the employee of a private employer ABC Limited not covered under the Payment of Gratuity Act,1972, , exempted gratuity would be the least of the following:

I.	Actual amount received	Rs 5,00,000
II.	Notified amount	Rs 3,50,000
III	half month's salary for every completed year	
	Based on the last 10 months' average salary	Rs 2,40,000
	(24 X ½ X 20000)	

Gratuity of Rs. 2,40,000 will be exempt and the balance of Rs 2,60,000 will be taxable.

Illustration-2

B retired on 15/6/2010 and got a sum of Rs 4,00,000 as gratuity. His average salary for the last 10 months was Rs 35,000 and he had rendered service for 22 years. Determine the amount of exemption of encashment of leave salary if he is:

a) a government employee,

b) employed by a concern on which the Payment of Gratuity Act, 1972 is applicable or

c) employed by a concern on which the Payment of Gratuity act is not applicable.

Solution:

a) If A is a government employee, amount received as gratuity on retirement is fully exempt**.**

b) If A is the employee of a private employer covered under the Payment of Gratuity Act, 1972, exempt amount will be the least of the following:

I.	Actual amount received	Rs 4,00,000
II.	Notified amount	Rs 3,50,000
III	15 day's salary based on last drawn salary	
	Rs. 35000 * 15/26 *22 years	Rs 4,44,230

Gratuity of Rs.3,50,000 will be exempt and the balance of Rs. 50,000 will be taxable.

c) If A is the employee of a private employer not covered under the Payment of Gratuity Act:, exempted gratuity would be the least of the following:

I.	Actual amount received	Rs. 4,00,000
II.	Notified amount	Rs 3,50,000
III.	half month's salary for every completed year	

Based on the last 10 months'average salary Rs 3,85,000

(22 X ½ X 35000)

Gratuity of Rs.3,50,000 will be exempt and the balance of Rs. 50,000 will be taxable.

5.6. Commuted Pension (Section 10(10A) :

Pension is periodical payment made regularly by the employer to the employee after his retirement or death as a reward for his past services. Such regular pension paid on a recurring basis, whether monthly or annually is taxable in the hands of all employees – government or private.

Some employers 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 or uncommuted pension is fully taxable in the hands of all employee, whether government or non-government.

ii.Commuted pension: Tax treatment of commuted pension will be as follows:

- In case employees of the Central or State Government or employees of a Local Authority or employees of a Statutory Corporation such lump sum pensions received in accordance with service rules is **exempt** from Income-tax.
- In case of other employees receiving such lump sum pension:-
  - ✓ If the employee had not received any gratuity on termination of employment, **half of the total value** of pension will be exempt and
  - ✓ If the employee had received any gratuity on termination of employment, **one-third of the total value** of pension will be exempt.

Illustrations-3 :

3. Determine the amount of taxable pension in the following cases:-

a. A receives a monthly pension of Rs 50,000 from the government.

b. A receives a monthly pension of Rs 50,000 from his employer being a private company.

Solution:

In both the cases, Uncommmuted Pension amounting to Rs. 50,000 received by A will be fully taxable under the head salaries . It is immaterial that the employee is a government employee or a private employee

Illustration- 4

4. A retires from government service on 1/6/2011. He gets a pension of 5000 p.m. till 31/12/2011. Then he opts for commutation of 40 per cent of the value of his pension for Rs 80,000 and continues receiving Rs 3,000 (60 per cent of 5000) on a monthly basis up to 31/3/2012.

Solution:

Computation of Taxable Pension

Particulars	Rs.
7 Months from 1/6/2011 to 31/12/2011 @ Rs. 5,000 After commutation of 40% (5,000 – 40%of 5,000 = 3,000 p.m. *3 months from 31/12/2011 to 31/03/2012)	35,000 9,000
Recurring Pension	**44,000**

The commuted pension Rs 80,000 will not be taxable in his hands as A is a government employee.

Illustration- 5

A retires from XYZ Ltd, a private sector company on 1/6/2011. He gets a pension of Rs 5,000 p.m. till 31/12/2011. Thereafter he opts for commutation of 60 per cent of the value of his pension for Rs 1,20,000 and continues receiving Rs. 2,000 (40 per cent of Rs 5,000) on a monthly basis upto 31/3/2012. He does not get any gratuity on retirement.

Solution:

Computation of Taxable Pension

Particulars	Rs.
Rs. 5,000 for 7 Months from 1/6/2011 to 31/12/2011 Rs. 2,000 for 3 months from 31/12/2011 to 31/03/2012	35,000 6,000
Recurring pension	41,000

Recurring pension of Rs 41,000 (Rs 5,000 for 7 months from 1/6/2011 to 31/12/2011and Rs 2,000 for 3 months from 31/12/2011 to 31/03/2012) received by A will be taxable even when he does not receive any gratuity.

Commuted Pension:

A receives Rs 1.20,000 on commutation of 60% of his pension. Full value of pension works out to Rs. 2,00,000 i.e. 120,000/60per cent).

As A does not receive gratuity, he will be entitled to an exemption equivalent to the least of the following two amounts:

- Actual amount received Rs 1,20,000
- 1/2 of full value of pension (50% of Rs. 2,00,000) Rs. 1,00,000

Commuted pension of Rs. 1,00,000 will be exempt .Balance Rs. 20,000 will be taxable.

Illustration- 6

Would it make any difference if A also gets a gratuity of Rs. 50,000 in illustration 5.

Solution:

Recurring pension of Rs. 41,000 will be taxable but exemption in respect of commuted pension will be equivalent to the least of the following two amounts :

- Actual amount received Rs 1,20,000
- 1/3 of full value of pension (33-1/3% of Rs. 2,00,000) Rs. 66,667

Commuted pension of Rs. 66,667 be exempt and the balance Rs. 53,333 will be taxable.

5.7. Leave Salary or Encashment of Leave Salary {Section 10(10AA)}

An employee can either enjoy the leaves granted to him or can encash the same. If the employee does not take leave and gets it encashed, the tax treatment would be as follows:

a. Encashment of leave salary during the **continuity of employment** is fully taxable in the year of receipt in the hands of the all kind of employees, whether government or private. However, the employee will be entitled to relief u/s 89.

b. Encashment of leave salary received at the time of termination from employment on account of **retirement or superannuation**, etc, by an employee:

a. Who is employed by the Central or State **Government, fully exempt** and

b. in case of any other **employees**, the least of the following is exempt and only the balance is taxable:-

i. Actual amount received

ii. Notified Amount currently Rs 3,00,000;

iii. 10 months' average salary or

iv. Cash equivalent of leave to be encashed i.e. (Leave Entitlement - Leave Availed) X Average Monthly Salary

Other Points

i. Salary for the purpose of calculating the exempt leave encashment is the total of basic salary, dearness allowance and commission on sales achieved by salesmen.

ii. Average salary means average salary of 10 months immediately preceding the retirement.

iii. Leave entitlement is to be taken at 30 days for each completed year of service.

iv. If leave is encashed from more than one employer, the exemption limit will be taken in respect of all the employers.

Illustration-7

After rendering services for 22 years and 9 months, A retires from his service on 1st June, 2011. He was drawing a basic Salary for 10 months preceding the month of his retirement at Rs 8000 p.m. Service Rules entitled him to avail 2 months' leave for every year or part thereof of service. A actually availed leave of 10 months' against his earned leave On Retirement, The employer paid him a sum Rs. 2,88,000 being Rs. 8,000 per month for 36 months i.e. (Total Leave earned 2 months for 23 years - 46 Months reduced by leave actually availed for 10 Months)

Compute amount of exemption of encashment of leave salary if his employer is:-
1) The State of Maharashtra or
2) XYZ Limited.
3) If leave encashment is paid during his employment:

Solution:

1) In this case since A is a government employee, amount received as leave encashment on retirement is **fully exempt.**

2) If A is the employee of a private employer XYZ Limited, amount received on leave encashment will be worked out as the least of the following:

I. Actual amount received	Rs 2,88,000
II. Notified amount	Rs 3,00,000
III 10 months' average pay	Rs 80,000
IV Cash equivalent of unavailed leave	Rs 96,000
{Max. 22 Months – 10 Months @ Rs.8,000 p.m.}	

Exempt amount will be Rs 96,000 and the balance Rs. 1,92,000 will be taxable.

3) If A has availed the encashment during the continuance of his employment, entire amount of Rs. 2,88,000 will be fully taxable

regardless of the fact that A is a government employee or a private employee.

IMP: Fractional Service are ignored NOT Rounded off . (24 years are taken instead of 24.75 years) Also note that under income tax rules, leave entitlement cannot exceed 3o days time is prescribed in Income Tax Rules. **The time and notified amount (wherever applicable in this lesson) should technically be available in question itself.**

5.8. Retrenchment compensation –S.10 (10B)

Any compensation received by a workman at the time of retrenchment or closure or transfer of undertaking including change of management resulting in interruption of service is exempt fully if it is paid under a scheme of closure approved by the central government and in other cases least of the following amounts would be exempt:

- ✓ Notified amount presently Rs. 5,00,000
- ✓ 15 days' average pay for every completed year of service or any part thereof in excess of six months
- ✓ Actual amount.

It may be noted that compensation under a Voluntary Retirement Scheme is also exempt u/s 10C. Where an assessee has to pay higher tax on account of such lump sum receipts , he is entitled to relief u/s 89 .This is subject to the condition that once an exemption under this section has been claimed relief u/s 89[1] wil not be available.

Illustration-8:

A workman was retrenched after 20 year and 10 months. His average salary was Rs 15,000 per month. He was paid Rs 180000 as the retrenchment compensation. Calculate the exempted amount.

Solution

The exempt amount will be least of the following:

- Actual Rs. 150,000
- Notified Rs. 500,000
- 10-1/2 months average salary 1,42.500
  (15 days for 20 years- 10 months rounded off to next number-Rs. 15,000 *10.5)

Compensation of Rs 157,500 will be exempt. Balance Rs.22500 will be taxable.

But he will not be entitled to relief u/s 89 if an exemption under this section has been claimed.

5.9. House Rent Allowance (Section 10-13A)

House Rent Allowance or HRA is paid by the employer to the employee to meet the housing expenses of the employee. HRA is exempt from tax U/s 10(13A) being the least of the following :

- HRA actually received.
- Rent paid by employee in excess of 10 per cent of salary during the previous year.
- 50 per cent of salary, if employee is residing in the 4 metro cities of Mumbai, Delhi, Chennai or Kolkata and 40 per cent of salary, if the employee is residing at any other place.

Salary for the purpose of calculating the amount of deduction from HRA means the aggregate of Basic Salary, Dearness Allowance and Commission received by salesman on sales achieved by him but it does not include other receipts such as overtime pay, conveyance allowance, etc.

From the above it follows that the **salary, actual rent, place of accommodation and amount of HRA actually received** are the four key factors that determine the amount of exemption of HRA

Illustration-9:

9. Calculate the amount of HRA exempt U/s 10(13A) in respect of an employee residing in Mumbai who was in receipt of basis salary of Rs. 65,000 Dearness allowance of Rs. 35,000 and HRA of Rs 25,000.and he paid the actual rent of Rs 15,000 per annum .

Solution:

Exemption of HRA will be the least of the following:

- Actual Rs 25,000
- Rent paid in excess of 10% of salaries Rs 5,000 i.e. Actual rent - 10% of salaries + DA or 15,000- 10%(65,000+35,000)
- 50 % of salary Rs 50,000.

HRA of Rs 5,000 will be exempt a. Balance of Rs 20,000 will be taxable.

Illustration-10

10. In the above case, What will be the position if the rent of Rs. 50,000 was paid?

Solution:

Exemption of HRA will be the least of the following:

- Actual Rs 25000
- Rent paid in excess of 10% of salaries Rs 40,000 i.e. Actual rent - 10% of salaries + DA or 50000- 10%(65000+35000)

- 50 % of salary Rs 50000.

HRA of Rs 25,000 will be exempt a. Balance of Rs 25,000 will be taxable.

Illustration-11:

11. Calculate the amount of HRA exempt U/s 10(13A) in respect of an employee residing in Agra who was in receipt of basis salary of Rs. 65,000 Dearness allowance of Rs. 35,000 and HRA of Rs 60,000.and he paid the actual rent of Rs 50,000 per annum .

Solution:

Exemption of HRA will be the least of the following:

- Actual Rs 60,000
- Cash Rent paid in excess of 10% of salaries Rs 40,000 i.e. Actual rent - 10% of salaries + DA or 50,000- 10%(65,000+35,000)
- 50 % of salary Rs 50,000

HRA of Rs 40,000 will be exempt and balance Rs 20,000 will be taxable.

5.10. Pension to Gallantry award winners- S. 10(18)

Any pension given to winners of notified gallantry awards like Param Vir Chakra, Mahavir Chakra , Vir Chakra is fully exempt u/s 10(18) .

6. TAXABLE VALUE OF CASH 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 –

- ✓ Fully taxable,
- ✓ partially exempt and
- ✓ fully exempt cash allowances.

It may be noted that some allowances are totally exempted. Some are conditionally exempted such as HRA. Exemption in some cases depends upon the amounts spent and in some cases like Transport Allowance exemption is allowed at *ad hoc* amount the may be prescribed from time to time. Some of these allowances are dealt with in the paras to follow.

6.1. Entertainment Allowance- S.16 (ii)

Most employers grant entertainment allowance to the employee for entertaining various business relations and clientele of the employer. . No exemption is available to non-government employees or employee in the private sector even if the amount may have been actually spent.

Government employees are allowed a deduction, which is the least of following: -

- Rs 5,000 per annum.
- 20 per cent of Basic Salary
- The amount of entertainment allowance actually received

This amount is granted as a deduction. Hence full amount will be first added in the salry income and then the deduction will be worked out.

6.2. Dearness Allowance (S.15 & 17)

Dearness Allowance is the allowance paid by the employer to the employee to meet the increased cost of living. Whole of the dearness allowance is taxable as salary income in the hands of the employee although it is a compensatory allowance against high prices. 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.

6.3. City Compensatory Allowance

City Compensatory Allowance is paid to employees posted in big cities to compensate the high cost of living in cities like Delhi, Mumbai etc. However, it is fully taxable.

6.4. Non practicing Allowance

Non practicing Allowance normally paid to compensate professionals like doctors, chartered accountants, engineers scientists etc. who are in government service and are banned from doing private practice is fully taxable.

6.5. Warden or Proctor Allowance

Warden or Proctor Allowance is paid in educational institutions for working as a Warden of the hostel or as a Proctor in the institution and are fully taxable.

6.6. Deputation Allowance

Deputation Allowance is paid to an employee sent from his permanent place of service to some place or institute on deputation for a temporary period and is fully taxable.

6.7. Overtime Allowance

Overtime Allowance paid to an employee putting in extra working hours over and above his normal hours of duty, he is given overtime allowance as extra wages is also fully taxable.

6.8. Fixed Medical Allowance:

Medical allowance is fully taxable even if some expenditure has actually been incurred for medical treatment of employee or family. However, reimbursement of medical expenses is exempt upto Rs. 15,000.

6.9. Servant Allowance

Servant Allowance, if paid in cash is fully taxable whether or not servants have been employed by the employee.

6.10. Tiffin / Lunch Allowance

While Cost of Lunch provided to employees on their work place or even redeemable coupons is a tax-free perquisite, Tiffin / Lunch Allowance paid in cash is fully taxable. It is given for lunch to the employees. Some companies have an arrangement with restaurants for providing lunch to the employees in exchange of coupon issued by them. The CBDT has clarified that value of such coupons will not be taxed provided some conditions are satisfied.

6.11. Transport Allowance- S 10(14)

Any allowance or benefit given to meet the expense wholly and necessarily in the course of employment is fully exempt u/10(14) subject to the assessee presenting the proof in this regard. CBDT on its part has notified some allowances and the extent of exemption available thereon. Transport allowance is one of such allowances. Transport allowance is given in order to meet conveyance expenses of the employee from place of residence to place of work and back. Such transport allowance is also taxable in the hands of the employee. However a sum of Rs 800 per month is allowed as an exemption from the taxable transport allowance under Rule 2BB.

For example if the amount of transport allowance is Rs 1,000 per month, the amount taxable will not be Rs. 1,000 but will be Rs 1,000 – Rs 800 i.e. Rs 200 per month. Therefore in a year of 12 month, the taxable amount will be Rs. 2,400 only. In case of handicapped employees, the amount of exemption is Rs. 1600/- p.m. in place of Rs. 800.

6.12. Education Allowance:

Education Allowance is given by an employer to employees to meet the education expenses of his children. It is taxable in hands of employee. However, under rule 2BB a sum of Rs100 per month per child subject to maximum of 2 children is

allowed as exemption from total education allowance received by the employee in a given year. If the children of the employee are residing in a hostel, an additional exemption of Rs 300 per month per child subject to maximum of 2 children is made available to the employee. Therefore if the employee has 2 children and who are residing in a hostel and the employee is giving total education allowance of Rs 1000 per month, the taxable amount will be (1000-800) i.e. Rs 200 per month only.

6.13. 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 Rs. 6,000 per month, whichever is less.

6.14. Foreign allowance

This allowance is usually paid by the government to its employees being Indian citizen posted out of India for rendering services abroad and it is fully exempt from tax.

6.15. Allowances to Judges

Allowance to the judges of the High Courts and the Supreme Court of whatever nature are exempt from tax.

6.16. Allowances by UNO

Allowances paid by the Unites Nations organization to its employees are fully exempt from tax.

6.17. Other allowances

All the other allowances like family allowance, project allowance, Marriage allowance, education allowance, and holiday allowance etc. not covered under specifically exempt category, are fully taxable in the hands of the employee. However if those allowances are given for official purposes, deduction of amount actually spent from those allowances by the employee in meeting the official expenses will be allowed at a deduction u/s 10(14) from the total amount of allowances received. For example if the employer pays uniform allowance to an employee for meeting the cost of uniform and the employee has actually spent the allowance for purchasing the uniform, then no amount of such uniform allowance will be taxable in the hands of the employee. If say the allowance granted is Rs 5,000 and the employee has spent only Rs 4,000, then Rs 1,000 will be taxable in the hands of the employee. Some other examples of these allowances paid for meeting official expenditure incurred exclusively in performance of official duties are travelling allowance, daily allowance, conveyance allowance, helper allowance, research allowance besides the uniform allowance.

7. TAXABLE VALUE OF PERQUISITES

Definition and Meaning of Perquisites:

Perquisites or "perks" are defined as any casual emolument or benefits attached to an office or position in addition to salary or wages. . Such benefits are normally given in kind and not in cash but should be capable of being measurable in money terms.

Perquisites are taxable and included in gross salary only if they are:

-allowed by an employer to an employee,

-allowed during the continuation of employment,

-directly dependent on service,

-resulting in the nature of personal advantage to the employee and

-derived by virtue of employer's authority.

Under S. 17(2) the perquisites include:

-Value of rent free a**ccommodation** provided to the employee by the employer.

-Value of concession in the matter of **rent** in respect of accommodation provided to the employee by his employer.

-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 Rs.50,000.

-Any sum paid by the employer towards any obligation of the employee

-Any sum payable by employer to effect an assurance on the life of assessee

-The value of any other fringe benefit given to the employee as may be prescribed.

8. CLASSIFICATION OF PERQUISITES

U/s 17(2), which deals with the perquisites, the perquisites classified in three broad categories:

- Perquisites taxable in all cases
- Perquisites not taxable at all
- Perquisites taxable only in the hands of specified employees only

A. Perquisites taxable in all cases:

U/s 17(2) the following perquisites are taxable in the hands of all type of employees, whether specified or not:

1. Value of Rent free house provided by employer
2. Value of 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.

B. Perquisites which are tax free for all the employees

Section 17 specifically states the some benefits will not be taxed at all in the hand of the employees and as such they are exempt from income tax .these perquisites are given below:

i. Medical benefits within India :

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 a 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.

c) 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 Rs.15,000.

ii. Medical benefits outside India

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 Rs.2,00,000.

iii. Medical Health Insurance within India

Following are exempted perquisites in respect of medical Health Insurance

- Premium paid by the employer on health insurance of the employee under an approved scheme u/s 36(1)(ib).
- Premium on insurance of health of an employee or his family members paid by employer on any scheme approved u/s 80D (Mediclaim).

iv. ESOP or Sweat Equity

Any benefit provided by a company free of cost or at a concessional rate to its employees by way of allotment of shares, debentures or warrants directly or indirectly under any Employees Stock Option Plan or Scheme **ESOP** of the company offered to such employees in accordance with the guidelines issued in this behalf by the Central Government. However, the difference between the fair Market Value and the issue price will be treated, when such equity is issued at concessional price, as the taxable perquisite value of ESOP

e. Transport

Amenity or benefit granted or provided free of cost or at concessional rate for use of any vehicle provided by a company or an employer for journey by the assessee from his residence to his office or other place of work, or from such office or place to his residence,

f. Refreshments

Refreshment provided by an employer to the employee during working hours in office environment

g. Others:

a. Value of Leave Travel Concession in India.

b. Amount spent by the employer as its contribution to staff welfare schemes.

c. Laptops and computers provided for personal use.

d. 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.

e. Recreational facilities extended not to a particular employee but to a class of employees.

f. Amount spent on training of employee or fees paid for refresher course.

g. Telephone provided to an employee at his residence.

h. Goods manufactured by the employer sold to employees at concessional rates

i. Allowances to employees of UNO

Since FBT has been discontinued, value of cars and other perquisites will be taxable in the hands of the employees.

C. Perquisites taxable in case of Specified Employees only

U/s 17(2)(iii) the value of any benefit or amenity granted or provided free of cost or at concessional rate **Specified Employees only** will be taxable

Specified Employees means an employee who is

- a **director** of or
- who has a **substantial interest** i.e. more than 20 per cent voting power in the company; where he is employed or
- Any other employee (of any employer including a company) whose income [under the head Salaries **exceeds fifty thousand rupees**

Salary for this purpose means salary due from, or paid or allowed by, one or more employers, exclusive of the value of all benefits or amenities not provided for by way of monetary payment,

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
5. Any other benefit or amenity

9. VALUATION OF PERQUISITES:

Perquisites are taxable in the hands of the employee. However since they are paid in kind, notional monetary the value of the perquisites must be determined in order to get the taxable amount of perquisites. There are some broad principles for determining the method of calculation of value of taxable perquisites. In brief theses principles may be stated as follows:

- If the perquisite is entirely for personal benefits, then whatever the employer has spent for providing those perquisites will be added to the salary income of the employee.
- If the perquisite is given by employer to employee for official purposes only, then such perquisites are not be treated as taxable perquisites in the hands of employee.
- Perquisites which are partly used for personal purposes and partly for official purposes - In such cases a reasonable amount of the value of perquisites which is used for personal purposes only will be added to the salary income of the employee.

Though the actual valuation rule are beyond the scope of the syllabus, general principles for valuation of perquisites may be considered

a. Accommodation & Furniture

Valuation of furnished and unfurnished accommodation is made according to Valuation Rules. If the furnishings are owned by the employer then 10 per cent of the cost will be added to the value of accommodation.

b. Transport

Broadly no perquisite value is taken in the hands of individual employees in three cases:

- Common transport is provided for all the employees, e.g. a bus,
- If the employer is in the transport business.
- If a car is provided only for official use or for the purpose of travel from residence to office

In other cases a reasonable cost of such transport facilities will be treated as taxable value of perquisites in respect of such facilities.

If the car has been provided for personal uses only, then the taxable amount is reasonable expenses on the car maintenance plus depreciation on the car as per income tax rules if the car is owned by the employer.

If the car is used for private as well as for official purposes then a reasonable proportion of the above is the valuation of the car perquisite in the hands of the employee.

c. Domestic servant

Salary of domestic servants of employer paid by the employer, perquisite value will be taken as per rules.

d. Gas, water or electricity:

- If the employer himself is engaged in the business of providing supply of gas, water, or electricity, then there will **not be any taxable perquisite** in the hands of the employee in respect of such facilities.
- If the employer is not in the business of supply of gas, water or electricity, then the amount spent by the employee in providing the facilities to the employee will be the taxable value of perquisites in the hands of the employee provided the entire facilities are for the personal use of the employees only. Any amount recovered from the employee will be reduced from the perquisite value.
- 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)

e. Educational facilities:

- If the employer is a school, college or educational institution, then there will not be any perquisites taxable in the hands of any employee.

- If the employer is not a school, college or educational institution, but is engaged in some other business or profession, the value of school fees or colleges fees of the children of the employee paid by the employer will be the taxable value of perquisites in respect if such facility.
- If the children of the employee are allowed free education in an institute run by the employer where the employer is engaged in other activities, then the value of the perquisites is reasonable cost of education and deemed by the income tax officer in the hands of specified employees.

f. Medical facilities

- A sum of up to Rs 15,000 paid by the employer to the employee by way of reimbursement of medical expenses of the employee and his family will be exempt perquisite in the hand of the employee. Any payment made in excess of Rs15,000 will be taxable.
- If the treatment is made in a government approved hospital or recognized hospital, or in government hospital, then no value will be taken as the perquisite value in respect of such medical treatment reimbursement.
- If the medical treatment is done outside India, then up to the amount approved by the RBI for such treatment, no perquisite value will be added to the taxable income of the employee. If payments made by the employer to the employee in this connection exceed the amount approved by the RBI, then such excess will be treated as taxable salary in the hands on of the employee.
- If the employer himself is a medical institution, then provision of medical facilities will not attract any tax in the hands of the employee.

  In other words if an employer's own institution provides transport, education or medical facilities , there will be no taxable perquisite value in the hands of the employee.

10. PROFITS IN LIEU OF SALARY – S 17(3)

U/s 17 (3) profit in lieu of salaries includes:

i. Compensation for Termination of Employment or modification of Terms & Conditions

The amount of any compensation due to or received by an assessee from his employer or former employer at or in connection with the termination of his employment or the modification of the terms and conditions relating thereto;

ii. Payment from Employer from PF or Other Fund

Any payment (other than any pension, gratuity, HRA, Retrenchment compensation, etc) due to or received by an assessee from an employer or a former employer or from a provident or other fund , to the extent to which it does not consist of contributions by the assessee or interest on such contributions.

iii. Keyman Insurance Policy

Any sum received under a Keyman insurance policy including the sum allocated by way of bonus on such policy.

iv. Sums Received from Future or Former Employer

Any amount due to or received, whether in lump sum or otherwise, by any assessee from any person (A) before his joining any employment with that person; or (B) after cessation of his employment with that person.

v. Payment of Employee's Obligation Employer

Any sum paid by the employer in respect of any obligation which, but for such payment, would have been payable by the assessee;

vi. Payments from Certain Funds :

Any sum payable by the employer, whether directly or through a fund, other than a recognised provident fund or an approved superannuation fund or a Deposit-linked Insurance Fund established under section 3G of the Coal Mines Provident Fund and Miscellaneous Provisions Act, 1948 , or, as the case may be, section 6C of the Employees Provident Funds and Miscellaneous Provisions Act, 1952.to effect an assurance on the life of the assessee or to effect a contract for an annuity; and

Illustration-12

Ravindra, a Chartered Accountant was appointed as Finance Manager with ABC Bank on 1/4/2010 in the Salary grade of Rs. 12000 – 500 – 20000 – 1000 – 30000.

He was entitled to Leave Travel Concession for proceeding on leave of Rs. 4000. His actual expenditure on this account amounted to Rs. 5000.

As the bank is situated at a place where home food is available, Ravindra was offered Tiffin Allowance Rs. 6000, His actual lunch expenses amounted to Rs.10000

Reimbursement of medical expenses for treatment of X and his family in private clinic was Rs. 50,000

Besides, he enjoys the following perks:

The Bank also provided free unfurnished flat at Mumbai (rent paid by Bank: Rs.80,000). However the perquisite value of that Flat was Rs. 30,000.

The employer provided two watchmen (salary Rs .2,000 per month each).

Free use of Santro car for official use, car can be used for journey between office and residence.

Free refreshments provided at place of work (Rs. 100 per day for 200 days).

Compute Salary Income for the assessment year 2012-13

Solution:

Computation of Salary Income Ravindra for AY *2012-13*

Particulars	**Rs.**
Basic salary (12,000+500)*12	1,50,000
Leave Travel Concession (Exempt)	NIL
Tiffin Allowance (Fully Taxable)	6,000
Medical Expenses Reimbursed (50,000 – 15000)	35,000
Rent Free Accommodation (Given)	30,000
Watchmen's Salary (2,000 * 2 *12)	48,000
Santro Car only for Office use	NIL
Free Refreshments at workplace	NIL
GROSS SALARY	**2,69,000**

vii. Treatment of Annual Accretion to Provident Fund;

Provident Funds are fund established to provide for the retirement benefits of the employees. The Scheme of funds envisages annual contributions from both the employer and the employee and the accumulation of interest on the balances. The funds are of three types Viz.

- **A.** Statutory Provident Fund set up or established and administered by the Government.
- **B.** Recognised Provident Fund set up by others but recognised by the Commissioner of Income Tax
- **C.** Unrecognised Provident Fund set up by others but not recognised by the Commissioner of Income Tax due to non- compliance with the guidelines laid down for recognition.

Tax Treatment under various schemes is summarised below::

Fund	Employer's Contribution	Interest Credited	Payment on Retirement
Statutory	Exempt	Exempt	Exempt
Recognised	Exempt upto 12% Basic Salary.(Excess taxable)	Exempt up to 8.5% p.a. (Excess taxable) w. e. f 01/09/2010, 9.5% prior to that date Recently 9.5%. restored	Exempt subject to rules
Unrecognised	Exempt	Exempt	Employers' Contribution & interest thereon taxable u/s 17(3).

Their Points:

1. Employer's Contribution to all the three funds is exempt at the time of contribution.
2. If the P.F. is deducted from the salary of the employee, salary will have to be grossed up in all the three cases.
3. Employees' Contribution when received back on retirement is exempt in all the three above mentioned cases.
4. Interest on Employees' Contribution from Unrecognised Provident Fund will be treated as Income from Other Sources.

viii. Transferred Balance: - S. 7

When an Unrecognised Provident Fund is subsequently recognised, the balances standing in the Unrecognised Provident Fund are transferred to the Recognised Provident Fund. These balances are called transferred balances and are deemed to be the income of that year as per section 7. Such amount consisting of employees' contribution in excess of 12% of Basic Salary and interest credited in excess of 8.5% per annum are taxed as the salary under section 17(1).

11. DEDUCTIONS FROM SALARIES: - S. 16

Aggregate of taxable amount in respect of salary, various allowances and perquisites is called the Gross Salary. From the Gross Salary so arrived, Deduction are allowed u/s 16. Other than that, no further deductions are allowed under this head. **Standard Deduction has been discontinued w.e.f. A.Y. 2006-07** The following are the deduction available to the employee U/s 16:-

11.1. Entertainment Allowance: -S.16 (2)

Deduction in respect of entertainment allowance is allowed only **to the Government Servants**. Employees working in private institutions are not entitled to this deduction..

Amount of deduction leas of the following three sums:

- Actual amount
- Rs. . 5000 or
- 20% of basic salary

Amount actually spent on entertainment is not relevant.

11.2. Profession Tax:

The Profession Tax, paid by an employee in a given previous year, will be deducted from the gross salary in order to get the taxable amount of salary. Profession Tax is levied by state government on employment.

12. ILLUSTRATIONS

Illustration-12:

X is in negotiation with two employer A &B, who have made the following offers to X. Help him in making an appropriate choice.

Particulars	Rupees	
	A	**B**
Basic Salary	5,00,000	5,00,000
HRA – Actual Rent Rs. 200000	25,0000	0
Free House –fair rental value 50000	0	2,50,000
Transport Allowance	1,00,000	0
Free Use of Car – Amount spent		1,00,000
Education Allowance for one child	50,000	0
Free Education for 1 child. Amount spent	0	50,000
Gardener Allowance	60,000	0
Gardener's salary paid by employer		60,000
Salary	**9,60,000**	**9,60,000**

Solution:

Taxable salary from employer A

Basic Salary		5,00,000
HRA	2,50,000	
Less : Exempt (HRA or 50 per cent of salary or Rent paid less 10 per cent of salary 200000- 10% of 500000)	1,50,000	1,00,000
Education Allowance Less : Exempt (100*12)	50,000 1,200	48,800
Gardener Allowance		60,000
Transport Allowance Less : Exempt (800*12)	1,00,000 9,600	90,400
Taxable Salary		**7,99,200**

Taxable salary from employer B

Basic Salary	5,00,000
Free House Value	50,000
Free Education for 1 child	50,000
Gardener's Salary(120 * 12)	1,440
Free Car	1,00,000
Taxable Salary	**8,51,440**

Since Taxable salary will be less with B, He should be preferred to.

Illustration -13 :

M is offered an employment by XY Ltd., Mumbai with the following two alternatives:

PARTICULARS	I	II
	Rs.	Rs.
Basic Salary	1,70,000	1,70,000
Bonus	6,000	6,000
Education Allowance for 2 children	10,200	--
Education facility for 2 children in an		
Institution maintained by the employer	--	10,200
Sweeper Allowance	10,000	--
Free Sweeper	--	10,000
Entertainment Allowance	6,000	--
Club Facility	--	6,000
Conveyance Allowance for personal use	12,000	--
Free Car Facility for Personal Use	--	12,000
Medical Allowance	18,000	--
Medical Facility for M and Family Members in own hospital	--	18,000
Free gas, electricity and water supply	--	4,500
Fair Rent Rent-free unfurnished house:	24,000	24,000

M is neither a director nor he has substantial interest in the company. Which of the two alternatives he should opt for on the assumption that both the employer and the employee will contribute 10% of salary towards unrecognised provident fund?

SOLUTION:

PARTICULARS	I	II
	Rs.	Rs.
Income from Salary		
Basic Salary	1,70,000	1,70,000
Bonus	6,000	6,000
Education Allowance (10,200 - 2,400)	7,800	Exempt
Education Facility	--	Exempt
Sweeper Allowance/Facility	10,000	--
Entertainment Allowance/Club Facility	6,000	6,000
Conveyance Allowance/Car Facility	12,000	Exempt
Medical Allowance/facility	18,000	--
Allowance for gas/electricity/water/free facility	4,500	--
Rent free unfurnished house	13,430	7,600
Gross Salary	**2,47,730**	**1,89,600**

Since taxable income is lower in option II, it should be preferred.

13. SELF ASSESSMENT QUESTIONS

1. What is Salary?
2. Discuss the difference profits in lieu of salary and perquisites.
3. Discuss various deductions available under the head salary.
4. Discuss the tax treatment of the perquisites in case of specified and non-specified employees.
5. "It is generally said that non specified employees pay less tax as compared to specified employees". Do you agree?
6. .Rajesh is an employee of ABC Ltd. Since 1997 he is receiving entertainment allowance of Rs. 500/- p.m. He submits following further information as on 31.03.12:
   - Net Salary of Rs. 4,000/- p.m. (including entertainment allowance of Rs. 500/- p.m. but after deducting income tax Rs. 500/-, Provident Fund Rs. 500/- and Profession tax Rs. 70/-)
   - He is provided car for his exclusive use during office hours for office work. The petrol and other maintenance expenses come to Rs. 12,000/- p.a.
   - Received Leave Travel Concession for himself and his family for proceeding on leave to hometown of Rs. 5,000/- as prescribed, while actual amount spent by him was Rs. 3,500/-.
   - During the year he received free services of a cook. (Cost to the employer Rs. 4,400/-)
   - Received Rs. 8,000/- on encashment of leave to his credit.

   Compute his taxable salary.
7. Rita was an employee of R India Ltd since 1968 covered by the Payment of Gratuity Act, 1972, retired on 31st January, 2012 after 35 years and 7 months' service. At the time of retirement his employer paid him gratuity of Rs. 65,000/- (exempt u/s 10(10) Rs. 51,000/- and he received Rs. 50,000/- being the accumulated balance of recognised Provident Fund. The due date of salary and allowance etc was 1st day of the next month and were paid on due date. He was entitled to a monthly pension of Rs. 400/- with effect from 1st day of February 2012 which becomes due on the last day of the month.
8. Compute the taxable income of Mr. Hitesh for the AY 2012-13 on the basis of the following further information:
   1) Basic Salary Rs. 2,500/- p.m.
   2) House Rent Allowance Rs. 400/- p.m. Taxable value is 50% of the amount received.
   3) Project Allowance paid during the year Rs. 12,000/-.

4) Bonus paid during the year Rs. 3,600/-.

5) In retirement, on encashment of earned leave at his credit of 15 months he received Rs. 37,500/-. (Exempt u/s 10(10AA) Rs. 24,600/-)

9. Suhas Desai submits the following information pertaining to the year 31.3. 2012:

   a) Basic Salary Rs. 5,000/- p.m.

   b) Dearness Allowance Rs. 3,000/- p.m.

   c) Bonus @ 20% on salary plus Dearness Allowance

   d) Employee contribution 12.5% of basic salary and dearness allowance to recognised Provident Fund every month. Employer also contributes an equal sum.

   e) Interest on balance credited to his recognised Provident Fund Account @ 14% p.a. Rs. 17,500/-

   f) House Rent Allowance Rs. 10,000/- p.a.

   g) Profession tax paid by employee Rs. 840/-.

   h) He retired from services on 31.3.2010 opting or 60% commutation of pension and received Rs. 2, 40,000/- as the only terminal benefit.

   Compute his income from salaries for the AY 2012-13

7

INCOME FROM HOUSE PROPERTY
(Sections 22 to 27)

Synopsis:

1. Introduction and Objectives
2. Basic Concepts
3. Basis of Charge – S.22
4. Basic Conditions
5. Deemed owner - S.27
6. Income from House Property Exempt from tax - S 10
7. Computation of Income from House Property
8. Annual Value
9. Determination of Gross Annual Value - fair rent, ratable value and standard rent as the determinants
10. Determination of Net Annual Value and computation for various properties:
11. Self-Occupied Business Property
12. Self-occupied Residential Property (SOP)
13. Let-Out Properties
14. Property let-out for part of the year and partly self-occupied
15. Property partly let-out and partly self-occupied
16. Co-ownerships
17. Miscellaneous- Arrears , Losses , TDs and no other deductions
18. Illustrations and
19. Self - Examination Questions.

1. INTRODUCTION:

The head "Income from house Property" is different from other heads of income in one significant respect. It covers not only the actual income but also the notional income. As such, the concept of house property and the computation of income from house property have a significantly different meaning.

The lesson explains what is taxable under the head and how it is taxed. In the process it also deals with the deductions available

for the Income from House Property, items not deductible deemed incomes, joint ownership, etc.

2. BASIC CONCEPTS

Sections 22 to 27 of the Income Tax Act deal with the basic concepts of Income from house property.

S 22 defines the scope of Income from House Property.

S. 23 prescribes the mode of computation of income

S. 24 describes the amounts deductible therefrom.

S. 25 deals with the amount not deductible

S. 26 deals with the income of co-owners of a property.

S. 27 gives the cases where a person not being an owner of he property will be taxed as the deemed owner of such property.

3. BASIS OF CHARGE: S. 22:

Section 22 defines the basis of charge under the head Income from House Property. It states that Annual Value of Property consisting of **any building or lands appurtenant thereto** of which the **assessee is the owner**, shall be chargeable under the head Income from House Property. This is however not applicable to property occupied for the purpose of assessees own business or profession.

4. BASIC CONDITIONS: -

In order to tax any income under this head, the following basic conditions must be satisfied namely –

a. There must be property consisting of buildings or land appurtenant or adjacent thereto.

- Building may any habitable four-wall structure covered by a roof. It is immaterial whether the building is residential or commercial such as warehouse, office or factory godown, wedding hall, auditorium, business centre, etc.
- Land appurtenant means land connected or adjacent to the building. Some examples are Open space, approach roads, courtyard, parking place, compound walls, etc, compounds, courtyards, backyards, playgrounds, parking spaces, etc

b. The property must be owned by the assessee. 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.
- Any income from a property which is not owned by the assessee, will not be treated as "income from house property" but as other income and other provisions of the Income Tax Act will apply in this connection. Thus, income from subletting of rented premises will be either treated as business income or as income from Other Sources.
- The assessee is required to be the owner in the previous year only. If the ownership of the property changes later, it is immaterial.

c. The property should either be let-out or used for own residence but, the property must not be used for the purpose of assessee's own business or profession.

d. All other properties are not covered under this head. Thus Rental Income from a vacant plot of land is not chargeable to tax under this section unless it is appurtenant to a building. If a tenant sub-lets the property to another tenant, that income cannot be taxed under Income from House Property since the assessee is not the owner of the property.

5. DEEMED OWNER- S. 27:

Under section 27 some persons are treated as owners even though they are not the legal owners of the property, income from that property will be treated as income from house property in their hands. The following are such situations:-

i. An individual, who transfers any property for inadequate consideration or who gifts that property to his spouse or to a minor child other than a married daughter will be treated as deemed owner of that property. In such cases, though legally the owner of the property is spouse or minor child, the income from that property will be treated as income of this person who has transferred such property.

ii. The holder of an impartible estate will be treated as the owner of that entire property for example where an HUF jointly holds property on behalf of all its members, then joint HUF will be treated as the owner though legally the property in the name of an individual member of family.

iii. A member of co-operative society, company or other association of persons to whom a building has been allotted under a house building scheme of society will also be treated as deemed owner of that property.

iv. A person who has satisfied the provisions of section 53A of the transfer of property act will be treated as deemed owner of that property. Section 53A of the Transfer of Property Act deals with situations where the agreement for buying of property has not been registered with the appropriate authority but possession of the property is handed over to the purchaser in part performance of the contract. In such case the purchaser of the property will be treated as the owner of the property.

v. A person who has acquired right by way of long-term lease of property will be treated as the owner of that property and income from that property will be taxable in his hands as under house property income. For this purpose long term lease means lease for period of more than 12 years. 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.

6. INCOME FROM HOUSE PROPERTY EXEMPT U/S 10

In some cases the income from house property is exempt from tax u/s 10.

a. Income from a farmhouse used for agricultural purposes. S. 10(1)

b. Any one palace of an ex–ruler- S. 10(19A)

c. Property income earned by certain institutions / organisations/ persons etc such as

   i. A local authority S. 10(20)

   ii. A scientific research association S. 10(20),

   iii. An Institution for development of Khadi & Village Industries S. 10(23BB)

   iv. Khadi & Village Industries Board S. 10(23BB)

   v. A body for administration of charitable & religious trusts & endowments S. 10(23BBA)

   vi. Approved funds, educational institutions & hospitals S. 10(23C),

   vii. A trade union or association of trade union S. 10(24)

   viii. Resident of Ladakh district S. 10(26A)

   ix. Statutory corporations/ other institution or association finance by the government for promoting the interests of the members of the scheduled caste and scheduled tribes S. 10(26B)

x. Co-operative society for promoting the interests of the members of the scheduled caste and scheduled tribes S. 10(27)

xi. A political party S. 13

xii. Income from house property earned from property held for charitable purposes S. 11

d. Property which is used for own business or profession. If such property yields any income, such income will be treated as business income and not house property income. letting out to paying guest, employees' quarters and residence of partner are some of the business uses. S. 22

e. One property which is used by an individual assessee or an HUF assessee for purpose of self-occupation only and not for letting out to any person will be treated as exempt property and income from that property will not be treated as taxable income. S. 23(1). This benefit can not be availed by non-living entities like firms, companies, etc.

7. COMPUTATION OF INCOME FROM HOUSE PROPERTY:

Income from house property is charged on the basis of its annual value. Annual value is determined u/s 23. From the annual value so determined, deductions u/s 24 are allowed. These provisions would be dealt with in detail in the following paragraphs therefrom.

8. ANNUAL VALUE

S. 2(22) defines 'annual value' as the annual value determined under s. 23.

'Annual value' is the inherent capacity of the property to earn income or the amount for which the property may reasonably be expected to be let out from year to year. However, the property need not necessarily be let out. It is not the actual rent but the capacity to fetch rent that is important.

The annual value of a property will, therefore, depend upon the use of the property- self occupied, let out or partly vacant and so on.

9. DETERMINATION OF GROSS ANNUAL VALUE

9.1. Annual value of a house property is higher of the Actual Rent or its Reasonable Lettable Value **[RLV]-**S23(1)(a)

1. Actual Rent: means the rent received or receivable in respect of the property actually let out by the owner.
2. Reasonable Lettable Value **[RLV]** is the expected rent which the property might reasonably be expected to yield from year to year. This value may be computed whether the property is let out or not. **RLV** is estimated on the basis of the following factors:
   a. **Fair rent** or the rent of similar properties in the same locality. The fair rent may be different in different circumstances or different contractual obligations.
   b. **Municipal Ratable Value** or the value of the property fixed by the local authorities for the purposes of assessment of local taxes payable. Often Municipal Ratable Value is taken on the basis of the market rent receivable on the property and is therefore considered as a very reliable yardstick to determine the reasonable letting value of the property.
   c. **Standard Rent** or the rent fixed under the Rent Control Act to control or limit the prevailing rents in a locality. It only means that **the landlord can not charge more rent than the limit fixed under the law**. However, the landlord is free to charge lower rent than the rent fixed under the law. Thus actual rent can be more or less than the fair rent but can never exceed the standard rent.

   The following diagram depicts the legal position:

Gross Annual Value [GAV] Higher of the following	
Actual Rent	***Reasonable Lettable Value-RLV***
Limiting factor Standard Rent as per Rent Control Act RLV cannot Exceed Standard Rent	
Municipal Ratable Value	**Fair Rent**

Illustration-1:

Find out the Gross Annual Value from the details given below in respect of a premises :

Actual Rent. 10,000 per month.

Rent of similar premises in the area Rs. 15,000 per month.

Municipal ratable value Rs. 8000 per month

Standard Rent fixed under the Rent Control Act. Rs. 12,000 per month

Solution:

GAV = Higher of Actual Rent or RLV

And RLV is subject to the Standard Rent

Actual Rent Rs. 1,20.000 and RLV Rs. 1,80,000 Standard Rent Rs. 1,44,000

On Comparison of Actual Rent & RLV = 1,20,000 and 1,80,000

Higher amount is RLV of Rs. 1,80,000

Now RLV or Rs 1,80,000 cannot exceed the standard rent of Rs. 1,44,000 because the landlord cannot charge more than the standard rent of Rs,. 1,44,000.

Therefore, RLV will be restricted to Rs . 1,44,000 .

The GAV will be Rs.1,44,000 ***being the higher of the Actual Rent or RLV*** i.e Rs. 1,20,000 and Rs.1,44,000

Illustration-2:

What will be the GAV if the Standard rent in above case is Rs. 18,000 per month?

Solution :

Given Actual Rent Rs. 1,20.000 , RLV Rs. 1,80,000 & Standard Rent Rs. 2,16,000

RLV is higher than the actual rent .but lower than the Standard Rent of Rs. 2,16,000. RLV will be Rs 1,80,000 NOT 2,16,000 because a landlord is free to charge lrent lower than the . Standard Rent is a limit on maximum rent and not a mandate to command minimum rent.

Therefore, reasonable Lettable value will be Rs 1,80,000 **,** which is more than the actual rent of Rs. 1,20,000 hence GAV will be Rs. 1,80,000

Illustration-3

What will be the annual value of the property if the Actual rent in the above case is Rs. 20,000 per month; fair rent, ratable value and standard rent remain at the same level of Rs. 15,000, 8000 and 12,000 per month respectively.

Solution:

Given Actual Rent Rs. 2,40,000 , RLV Rs. 1,80,000 , Standard Rent Rs. 1,44,000 , Ratable Value Rs. 96,000

I. Actual rent Rs. 2,40,000

II. Compare Ratable value Rs. 96,000 and RLV Rs 1,80,000 – higher of the two is RLV- Rs. 1,80,000

III. RLV Rs. 1,80,000 and Standard Rent is Rs. 1,44,000 . RLV can not exceed the Standard Rent,. RLV will be limited to Rs1,44,000

IV. Compare RLV Rs. 1,44,000 with Actual Rent Rs. 2,40,000

Since actual rent of Rs 2,40,000 is more than the RLV Rs 1,44,000

Actual Rent of Rs. 2, 40,000 will be the gross annual value.

In fact the landlord charging more the standard rent of Rs 1,44,000 is illegal. But Income tax Act does not take into account the legality. Therefore, annual value will be taken at Rs. 2,40,000 being the actual rent received.

9.2. Comparison of Reasonable letting value and Rent received/ receivable- S.23(1(b):

As per Para 9.1 above, rent received or receivable and the reasonable letting value are determined and then compared and higher of the two sum will be taken as gross annual value. On comparison of the two following may be the possibilities:-

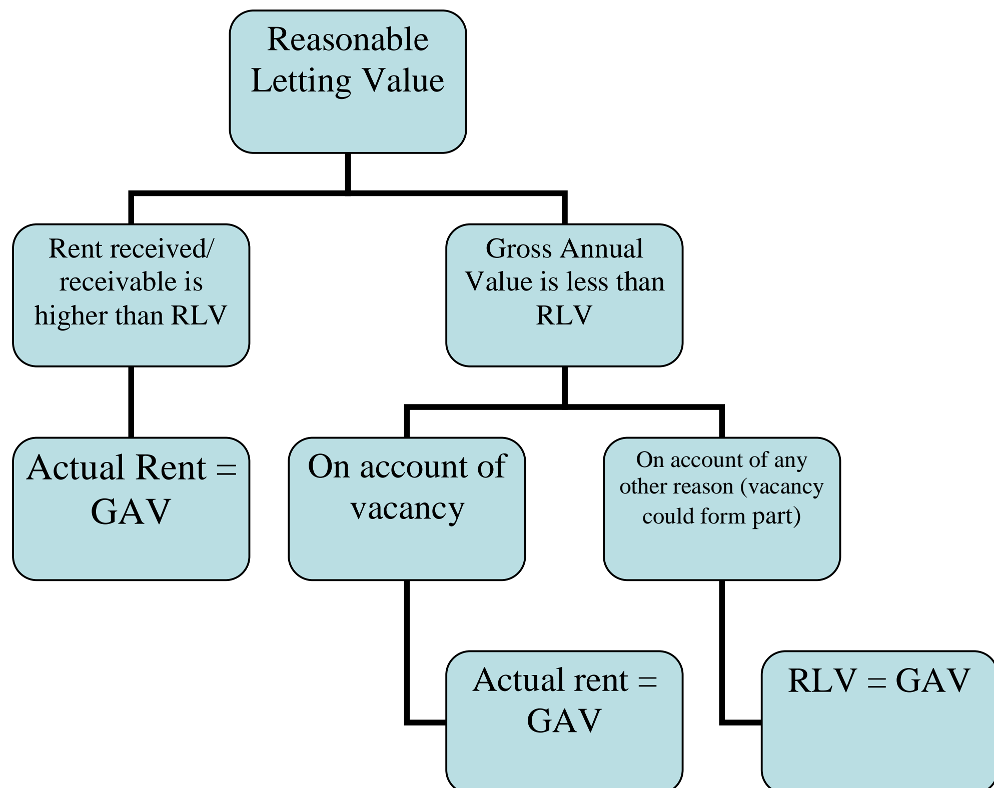
a. Actual rent received/ receivable is more than the reasonable letting value. In such a case actual rent will be the Gross Annual Value u/s 23(1)(b). OR.

b. If the position is reverse i.e. the reasonable letting value is more than the actual rent received/ receivable, There may, again be two possibilities :

   i. The reason for deficiency or shortfall between the actual rent the reasonable letting value is because of **vacancy only and no other reason,** such lower rent will be taken as the gross annual value u/s 23(1)(c). and

   ii. If the deficiency or shortfall is due to **any other reason,** reasonable letting value will be taken as the gross annual value.

The above position will be clear from the following diagram:



c. Actual rent is relevant only if the property is let out. A property which remains vacant or is nor let out at all or a self- occupied property cannot have any actual rent. In such a case reasonable letting value alone will be the guiding factor.

d. The amount of Rent actually received/ receivable during the previous year will be arrived after deducting rent for the period for which the property was vacant and unrealised rent or bad debts,

e. In case of composite rent, expenses on providing amenities to the tenant such as water will be deducted to find out the actual rent.

f. For the purpose of determining the Annual value, the actual rent shall not include the rent which cannot be realised 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-4

Find out the annual value of a house let out for @ Rs 2,000 per month. Reasonable lettable Value is Rs 20,000.

Solution:

Annual value in this case be the actual rent i.e. Rs 24,000 being higher than the reasonable lettable value of Rs 20,000

Illustration-5

What will be the GAV if the, reasonable lettable value is Rs 30,000 but the actual rent is Rs 2,000 per month.

Solution:

Annual value on this case be the reasonable lettable value i.e. Rs. 30,000 being higher than the actual rent of Rs. 24,000.

Illustration-6

A house was let out on a monthly rent of Rs. 20,000 for 8 months only. Remaining 4 months it remained vacant. Reasonable lettable value of the house is Rs. 2,40,000. What would be its annual value?

Solution

Actual rent is Rs. 1,60,000 for 8 months . But RLV is Rs. 2,40,000 for the full year. There is a shortfall of Rs. 80,000 compared to the reasonable lettable value.

Actual rent for full year will Rs. 2,40,000 , if there is no vacancy . Since the shortfall of Rs .80,000 is solely on account of vacancy, the gross annual value will be Rs. 1,60,000 being the actual rent. .

10. COMPUTATION OF NET ANNUAL VALUE AND INCOME FROM HOUSE PROPERTY:

In order to have proper understanding the provisions of Sec. 23, let us divide the house properties into different categories namely:-

- **i.** Self-occupied Business Properties.
- **ii.** Self-occupied Residential Properties (SOP)
- **iii.** Let-out Properties(LOP)

iv. Property let-out for part of year and SOP for part of year
v. Partly self-occupied and partly let-out
vi. Co-ownership

Each of these classes of properties is dealt within detail in the following paragraphs.

10.1. Self-occupied Business Properties:

Income from house property used for own business or profession is exempt from tax. If any rent or other income is generated from such property, the same should be treated as business income. Similarly, municipal taxes, repairs, insurance premium, and other expenses incurred on such property etc. will be admissible as business expenses.

10.2. Self-occupied Residential Properties (SOP);

U/s 23(2)(a) value of one residential house part thereof which is occupied by the owner himself for his own residence is taken as nil subject to two conditions :

a. The property or part thereof is not let-out actually for any part of the previous year and

b. No other benefit has been derived from such property.

10.3. Some points are important in respect of SOPs.

i. This exemption is available to individuals or HUF in respect of only one property, which will be treated as self-occupied and its annual value will be taken as Nil.

ii. If an assessee owns only one property, and can not occupy the same because he is engaged in employment or is carrying on a business or profession elsewhere, these provisions will apply *mutatis mutandis)* - Sec. 24(2).

iii. The exemption is available in respect of one self occupied property only. If the assessee owns more than one property all of which are self-occupied, then the assessee**, at his option, may choose any one property as self-occupied** by him.

iv. Remaining properties will be deemed or assumed to have been let-out. In respect of these deemed let out properties a notional rental value will be taken as if the property was let out as the taxable income in the hands of the owner of such property. Such properties are known as properties deemed to have been let-out.

v. In respect of properties deemed to have been let-out, a notional rental value will be treated as taxable income even if no rent has actually been received by the assessee. The notional rental value is determined in the same manner as if the property was let-out. All the deductions u/s 23 & 24 will be allowed in the normal manner on such property.

vi. Once the annual value of a SOP has been taken as nil, no further deduction will be allowed U/s 23 in respect of municipal taxes or U/s 24 except in respect of interest paid or payable on borrowed funds for purchase, construction, repair, renewal or reconstruction of house property. as per the following rules

10.4. Deduction of interest:

The deduction in respect of interest on borrowed funds will be allowed as per the following rules:

1. Where the loan is taken prior to 1 April 1999 deduction in respect of interest will be allowed to the extent of Rs. 30,000.
2. Where the loan is taken after 1 April 1999 for acquisition/ construction of house property, **Rs. 1,50,000** is deductible.
3. Where the loan is taken for repairs or renovation of the house property, deduction in respect of interest paid will be restricted to Rs. 30,000.
4. Interest is taken on accrual basis. Actual payment during the previous is not necessary.
5. Where the house property has been acquired or constructed with borrowed money, the interest on such borrowed money for the period prior to the previous year in which the property had been acquired or constructed shall be deductible in five equal annual instalments starting from the previous year in which the house has been acquired or constructed.
6. 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.
7. Interest payable on interest will not be allowed.
8. Brokerage or commission paid to arrange a loan for house construction will not be allowed.
9 Any loss arising under the head 'income from house property' may be set-off against the other heads of income in the same assessment year.

Interest on loan deductible on SOP		
LOAN TAKEN BEFORE 01/04/1999	**LOAN TAKEN ON OR AFTER 01/04/1999**	
	For Construction or Acquisition of house	For Repairs or Renovation of house
Rs 30,000	**Rs 1,50,000**	**Rs . 30,000**

Illustration-7

Find out the interest deductible U/s 24 for the assessment year if A borrows Rs. 25,00,000 @ 10% p. a. on 1/4/2004 to construct a Bungalow for own residence. ,

Solution:
Out of the interest payable Rs. 2,50,000, only Rs. 1,50000 will be allowed.

Illustration-8
What would be the amount of interest allowable if the money was borrowed in 1998.

Solution
The deduction would be restricted to Rs. 30.000.

Illustration-9
If the loan was used for repairs of the bungalow, what would be amount of deductible interest?

Solution
The deduction would be restricted to Rs. 30.000.

Illustration-10

If the construction of the Bungalow was completed in February 2007, what would be the amount of deductible interest?

Solution:
The loan was taken during the financial year in 2004-05 relevant to assessment year 2005-06. But the construction was completed during the financial year in 2006-07 relevant to assessment year 2007-08

For A.Y. 2005-06 and 2006-07, no interest will be deductible as during those two years, there was no house property chargeable to tax.

The total pre-construction interest for two years prior to the year of construction works out to Rs 5,00,000, which will be allowed in equal instalments from assessment year 2007-08 onwards for 5 assessment years. Subject to the overall limit of Rs. 1,50,000

13. Let-out Properties :
Following principles will be applicable for determination of annual value of properties let out including SOP deemed to be let out.

13.1. Determination of Net Annual Value – Deduction of Municipal Taxes:

Let-out properties are charged to tax at the net annual value (NAV). NAV is determined in following two steps:

Step 1- Determine the GAV as per section 23

Step-2 Deduct Municipal taxes **paid** by the **owner** from GAV (Proviso to S. 23(1).

Municipal taxes are taken on **cash basis** and **not accrual basis.**

Municipal taxes paid or borne by the tenant are not deductible

The resultant figure will be **Net Annual Value.**

13.2. Deductions under section 24:

From the net annual value following deductions are allowed:

i. Repairs and Collection Charges or Standard Deduction:

A lump sum deduction of 30% of the net annual value is allowed as deduction for repair and collection charges irrespective of whether the assessee has actually incurred the expenses or not. However, if the repairs are borne by the tenant, this deduction will not be allowed in the hands of the owner of the property.

ii. Repairs and Collection Charges or Standard Deduction on Arrears of rent:-S. 25B

U/s 25B where the assessee is the owner of a house property which has been let-out and has received any amount by way of arrears of rent not charged to income tax in earlier years, the amounts of such arrears will be taxable in the year of receipt and 30% of such arrears will be allowed as a deduction on account of repairs and collection charges.

iii.Interest :

Interest on funds borrowed for acquisition, construction, repair, renewal or reconstruction of house property or of fresh loan for repaying old loan for such purposes will be allowed on **ACCRUAL** basis.

iv. Pre- Construction Period Interest

Interest for pre-construction period is allowable in five equal instalments from the previous year in which such property was constructed or acquired. Significant points to be noted are:

- Interest on loans is taken on accrual basis.
- In case of let-out property, limit of 30,000/ 1,50,000 is not applicable unlike the SOP.

- Pre-construction interest is amortized 1/5th per year for 5 years in both the cases.
- Pre-construction period interest is calculated from the date of the loan to the end of the previous year before the previous year in which the house was acquired.

Illustration -11.

A took a loan on October 1, 2003 of Rs 10,00,000 @ 10% interest p.a for the construction of his house. The house was finally constructed on January 1, 2009. Calculate the pre-construction period interest and also mention the assessment years in which the deduction for such interest may be allowed.

Solution

Date of loan: October 1, 2003

Previous year in which house is constructed - 2008-2009

Assessment year in which house is constructed - 2009-10

End of the PY preceding the PY in which the house is constructed - March 31, 2008

Hence, pre-construction period = March 31, 2008 – October 1, 2003 = 4.5 years.

Pre-Construction period interest = Rs 10,00,000 X 10% X 4.5 = Rs 4,50,000

Amount of deduction in respect of pre-construction interest: Rs 4,50,000 X 1/5 = Rs 90,000

The deductions in respect of the pre-construction period interest would be available from the assessment year in which the house was constructed. Therefore, the deduction would be available in for five years from AY 2009-10 to AY 2013-14 of Rs 90,000 each per year.

14. Property let-out and self-occupied for part of the year

If a property is let-out for whole or any part of the year and self-occupied for the remaining part of the year, it shall be treated as let-out property and computation will be made accordingly by comparing actual rent with the fair rent for the whole property u/s 23(1). **It will not be treated as SOP** as S.23 (3) makes it clear the SOP shall not be let-out for any part of the year nor should any benefit be derived from it.

15. Property partly let-out and partly self-occupied:

If a part of the property – say one or two floors or few rooms have been let out and another part of the property is self- occupied, then for each portion the calculation will be made separately.

Relevant expenses like property taxes and interest will be allocated suitably for each portion and deductions will be allowed separately for each portion.

NOTE the difference between property let out /SOP for split period and with split portion used for letting out/SOP.

16. Co-ownership – Section 26:

Where a property is owned by more than one owners and the shares of such owners are definite and ascertainable, the property will not be assessed as an association of persons but share of each owner shall be included in his individual income. Supposing the property is occupied by the co-owners themselves, share of each owner will be treated as nil. Each of the co-owners would be entitled to the deduction in respect of interest subject to the limit of Rs 30,000 or Rs 1,50,000, as the case may be.

17. MISCELLANEOUS :

17.1. Recovery of arrears for periods from AY 2002-03 onward

Recovery of normal arrears of rent, if not taxes earlier , is taxable in the year of recovery and 30% deduction is allowable in that year S. 25B

17.2. Recovery of arrears for periods prior to AY 2002-03

Recovery of unrealisd rent earlier allowed as deduction u/s 24 upto Assessment Year 2002-03 and thereafter from the annual value, are taxable in the year of recovery but *30% deduction will not be allowed* (S. 25-A/ 25-AA)

17.3. TDS

No deduction in respect of interest payments is allowed if TDS is not deducted in respect of interest paid to a non-resident outside India without deduction of tax at source.

17.4. Set off and carry forward of losses :

- Loss under the House property will be allowed to be set off and carried forward for a period of 8 assessment years.
- Any loss arising under the head “Income from House Property” can be set off against income arising from other heads.

17.5. No other Deductions allowed ;

No deduction would be available in respect of charges like electricity, land revenue, ground rent, insurance, etc. even though they may be actual outgoings since the standard deduction of 30% is supposed to take care of all expenses.

18. PRACTICAL EXAMPLES :

1. Find out the Gross Annual Value in the following cases:-

Particulars	Property				
	I	**II**	**III**	**IV**	**V**
Municipal Value	5000	5000	5000	5000	5000
Rent Receivable	5200	5200	5700	5700	6000
Fair Rental Value	5600	5600	5600	5800	6100
Standard Rent under Rent Act	NA	5500	5500	5500	7300
Solution:					
	I	**II**	**III**	**IV**	**V**
Municipal Value	5000	5000	5000	5000	5000
Rent Receivable	5200	5200	**5700**	**5700**	6000
Fair Rental Value	**5600**	5600	5600	5800	**6100**
Standard Rent under Rent Act	NA	**5500**	5500	5500	7300
Gross Annual Value	5600	5500	5700	5700*	6100*

Notes:

i. In case I Fair Rent being highest and In case III Actual Rent being highest taken as GAV

ii. In case II Actual Rent is taken as GAV because fair rental value of Rs. 5800 is limited to Standard Rent of Rs 5,500

iii. In case IV Fair Rent is taken as GAV as in spite of being lower than the standard rent , it exceeds the actual rent

iv. Actual rent receivable being higher than the standard rent is adopted.

v. Standard rent is only a limiting factor. Fair rent cannot exceed standard rent, and is therefore, ignored.

2. A owns two houses, I & II. House I is let-out throughout the previous year. House II is self-occupied for nine months and let-out for three months on a monthly rent of Rs 5,000. Determine Taxable income, given the following details:-

	House I	House II
Municipal Value	40,000	50,000
Fair Rent	50,000	48,000
Rent Received	48,000	15,000
Municipal Taxes paid	4,000	5,000
Insurance Premium (not yet paid)	2,000	2,500
Ground Rent	1,000	1,500
Maintenance Charges	3,000	3,500
Electricity Bill	5,000	6,000

Solution:

	House I	House II
Gross Rental Value (For House II @ 5000 p.m	40,000	60,000
Less : Municipal Taxes paid	4,000	5,000
Net Rental Value	36,000	55,000
Less : Adjustment for Self-occupation		
(55000/12*9)	NIL	41,250
Net Adjusted Value	36,000	13,750
Less : Deduction u/s 24		
Repairs & Collection Charges30%	10,800	4,125
Taxable Income	25,200	9,625

19. SELF EXAMINATION QUESTIONS:

1) How will you determine the income from house property under the Income tax Act, 1961?
2) How will you determine the annual value of the property which is let out?
3) State the deductions to be made in computing income from house property.
4) Discuss briefly the various expenses and allowances that are deductible under the head “Income from House Property”
5) Mention the amounts which are not deductible from Income from House Property
6) Write a short note on property owned by co-owners

7) Explain briefly (a) Owner of a house property (b) A member of a co-operative society (c) Annual Value

8) What do you mean by "Self-Occupied house property"? How is the annual value of such property determined?

9) Explain briefly, house property "deemed to be let-out" and how the income from such house property is determined?

10) Enumerate the deductions available under Section 24 in computing "Income from House Property".

11) Is interest paid on a housing loan out of India allowable as a deduction?

12) Interest paid by the assessee on borrowed capital in the construction of the property, till the date of letting out – is it an admissible expenditure under the provisions of the Income Tax Act?

13) Discuss the provisions of Income Tax Act regarding unoccupied residential house?

14) Ownership is the criterion for assessment of Income from property under Section 22. However, there are instances in which the income from property is assessable in the hands of the assessee, who is not the legal owner thereof.. Enumerate these cases.

15) How is income from self occupied property or property meant for own occupation, but remaining wholly or partly unoccupied computed? Discuss.

16) Discuss tax liability of arrears of rent.

17) What is 'annual value'? How is the annual value of a let out house-property determined?

18) 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?

19) Explain the provisions of the Income Tax Act with respect to the computation of income from a self-occupied house property.

20) What deductions are allowed from the annual value in computing the taxable income from house property?

21) .Explain the tax treatment of unrealized rent.

22) 'It is only the owner of the house property who is chargeable to tax on income from house property'. Explain.

23) Lakdawala completed construction of a residential house on 1.4.1999. Interest paid on loans borrowed for purpose of construction during the 2 year prior to completion was Rs 20,000/-. The house was let out on a monthly rent of Rs.

4,000/-. Annual corporation tax was Rs. 6,000/-. Interest paid during the year is Rs. 15,000/-. Amount spent on repairs is Rs. 2,000/-. Fire insurance premium paid is Rs. 1,500/- p.a. The property was vacant for 3 months. Annual letting value as per corporation records is Rs. 30,000/-. Compute the income chargeable to tax under the head "Income from House Property" for the AY 2012-13

(Ans. Rs. 2,000)

24) Ram owned a house property at Chennai which was occupied by him for the purpose of his residence. He was transferred to Mumbai in June 2007 and therefore he let-out the property with effect from July 1, 2007 on a monthly rent of Rs. 3,000/-.The corporation tax payable in respect of the property was Rs. 6,000/- of which 50% was paid by him before 31.3.2007.Interest on money borrowed for the construction of the property amounted to Rs.20,000/- Compute the income from house property for the AY 2012-13

(Ans. Loss Rs.3,200)

25) Arvind commenced his construction of a residential house intended exclusively for his residence on 1.11.2002. He raised a loan of Rs. 5,00,000/- at 16% interest for the purpose of construction on 1.11.2006. Finding that there was an over-run in the cost of construction he raised a further loan of Rs. 8,00,000/- at the same rate of interest on 1.10.2007. What is the interest allowable under Section 24 assuming that the construction was completed on 31.3.2008?

(Ans. Loss of Rs. 1, 50,000 Hint: pre- construction interest to be amortized 1/5th)

26) From the following particulars of his property furnished by Shri S , Calculate income from house property:

i) One residential house actually let out for 10 months for total rent of Rs. 25,000. Fair rent of this house is Rs. 27,000 and municipal ratable valuation is Rs. 24,000. Total outgo on account of this house included repairs of Rs. 9,000, Municipal taxes of 18 months Rs. 9,000 and insurance premium of Rs. 1,500. Interest on funds borrowed amounted to Rs. 1,75,000.

ii) One residential house at Andheri is used for own residence. Fair rent of this house is Rs. 80,000 and municipal ratable valuation is Rs. 75,000. Total outgo on account of this house included repairs of Rs. 6,000, Municipal taxes Rs. 18,000 and insurance premium of Rs. 1,500. Construction of this house was complete in 2009 from the funds borrowed from HDFC. During the

current year, interest amounting to Rs. 90,000 was paid for the current year and Rs. 60,000 for the last year. A further interest of Rs. 65,000 was paid on loans taken for renovation necessitated due to heave rains. The interest pertains equally to this year as well as the last year.

27. State with reason whether the following incomes will be taxable as income from house property.

a) R lets out his house to Y, who uses it as his office.

b) R uses his house as the godown for the goods produced by his factory.

c) R rents out his property as residential quarters to the workers in his factory at a nominal rent of Rs.500 p.m.

d) R enters into a written agreement to purchase a property from Y for Rs. 5,00,000 . He has paid the consideration and taken the possession of the Property but the property is yet to be registered in the name of R.

e) R owns a property, which is given on lease to Y for a period of 6 years, lease rent being Rs.10,000 per month. Y has a right to get the lease renewed for a further period of 6 years.

f) R owns a property, which is given on lease to Y for a period of one month, Y has a right to get the lease renewed for a period of one month, in each subsequent month, and such renewal is possible with mutual consent till 2020.

g) R owns a property, which is given on rent to Y. Y annually pays Rs.1,50,000 as rent of the building as well as the charges for different services (like lift, security, etc.) provided by R.

h) R owns an air-conditioned furnished lecture hall. It is let out, annual rent being Rs 5,00,000, which includes rent of building as well as rent of air conditioner and furniture.

(Ans : a, d,e, f,g)

8

PROFITS AND GAINS OF BUSINESS OR PROFESSION
(Sections 28 to 44)

SYNOPSIS:

1. Introduction and objective
2. Concept of business
3. Mode of computation
4. Deductions Expressly Allowed Under The Act
5. Specific Deductions -S.36
6. General deductions
7. Specific Disallowances
    - 7.1. Disallowances for any assessee
    - 7.2. Disallowances for any firm
    - 7.3. Disallowances for any AOP/ BOI
    - 7.4. Disallowances for all assessees
8. Disallowances in respect of certain unpaid liabilities
9. Typical Illustrations
10. Self Assessment Questions

1. INTRODUCTION AND OBJECTIVE

Business is the bloodline of an economy as the business contributes the substantial revenue of the state. The ongoing tussle between the business to save the taxes as much as it can and the zeal of the state to extract tax as much as it can has made the head "profits and gains from business or profession" significant and complex.

The lesson intends to explain this most important and complex piece of law in simple terms beginning from the basic concepts of business, profession, vocation, trade, commerce, manufacture. The lesson also covers computation of taxable profit and gains from business & profession, various general and specific deductions including depreciation allowable and items not allowed as deduction.

2. CONCEPT OF BUSINESS :

S.2 (31) defines business:
"Business includes any trade, commerce, manufacture or any adventure or concern in the nature of trade, commerce or manufacture".

The definition is an inclusive one . It covers not only the business in common parlance i.e. dealing in goods but also trade, commerce, manufacture, any adventure or concern in the nature of trade, commerce or manufacture, rendering of services, profession and vocation

While the core trading activities of dealing in goods and services for profit are in the domain of terms like trade, commerce and business, production of something altogether new is called manufacture. Personalised services like doctors, architects, lawyers, chartered accountants even priests, palmists and astrologers form the profession and vocation.

Following points, in this connection are noteworthy;

(i) Legally, there is not much difference between business and profession, although there are some provisions dealing with such specific activities.

(ii) Business may be legal or illegal, organised or unorganised, regular or occasional, and may or may not require the personal talents or skill. It will nevertheless be business and attract tax liability.

(iii) Business need not be organised, systematic or regular. A single transaction like purchasing plot of land for resale after development of the land and subdivision into smaller plots was held as an adventure in the nature of trade or commerce or manufacture. .

(iv) Thus, diverse activities like delivering discourse, performing pooja, acting, redevelopment of land and even smuggling have been judicially held to be included in the definition of business.

3. SCHEME OF COMPUTATION -SEC. 28-29

3.1. Basic Scheme of computation

S 14 includes "profit and gains from business and profession" as one of the heads of income and S 28 to S 44D deal with various aspects of business income. The broad scheme of computation is as follows:

- S. 28 as the charging section defines as to what constitutes business income.
- S 29 provides for mode of computation of business income by deducting expenses from income.
- Sections 30 to 35 cover expenses allowed to be deducted only by some of the businesses, which are expressly allowed as deduction
- Sections 36 and 37 deal with general deductions allowed to all the businesses.
- Sections 40, 40A and 43B cover expenses which are not deductible in certain circumstances
- Recent trend is to compute profits on presumptive basis in some cases like 8% of turnover for small resellers and small construction contractors, lump sum hire charges of vehicles, certain etc. These provisions are contained under section 44.

3.2. Chargeable income :

Section 28 provides a broad list of income chargeable to tax under the head "Profits and gains of business or profession":

i. The profits and gains of any business or profession which was carried on by the assessee at any time during the previous year;

ii. any compensation or other payment due to or received by any person in connection with the termination of his management or the modification of the terms and conditions relating thereto and relating to ;

a. management of affairs of an Indian or other company

b. agency for business activity in India or

c. vesting of the management of any business or property in favour of the government or any corporation owned by the government under any law in force.

iii. Income derived by a trade, professional or similar association from specific services performed for its members;

iii(a) Profits on sale of import licences

iii(b) Export incentives by way of Cash assistance (by whatever name called) received or receivable by any person against exports under any scheme of the Government of India

iii(c) Any duty drawback i.e. refund of customs or excise duty paid against exports ;

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

v Any interest, salary, bonus, commission or remuneration, by whatever name called, due to, or received by, a partner of a firm from such firm and to the extent the same has been allowed to be deducted by the firm u/s 40(b).

v. (a) any sum, whether received or receivable, in cash or kind, under an agreement for, if the same is not chargeable as capital gain or where the sum is received under UN Environment Programme relating to Ozone layer for:

a. for not carrying out any activity in relation to any business; or

b. not sharing any know-how, patent, copyright, trade-mark, licence, franchise or any other business or commercial right of similar nature or information or technique likely to assist in the manufacture or processing of goods or provision for services:

In this connection, following points are important:

- Agreement includes any arrangement or understanding or action in concert.
- Agreement may be formal or informal
- It may or may or not be intended to be legally enforceable
- Service means service of any description which is made available to potential users and includes the provision of services in connection with business of any industrial or commercial nature such as accounting, banking, communication, conveying of news or information, advertising, entertainment, amusement, education, financing, insurance, chit funds, real estate, construction, transport, storage, processing, supply of electrical or other energy, boarding and lodging.

vi. Any sum received under a Keyman insurance policy including the sum allocated by way of bonus on such policy.

vii. Amount recovered on account of bad debts allowed in the earlier years.

viii. Profits on sale of capital assets if used of scientific research and allowed in the earlier years.

The section also clarifies that speculative transactions of an assessee of such a nature as to constitute a business, shall be deemed to be distinct and separate from any other business. Speculative transactions are defined to be the transactions settled by payment of difference in price of goods or securities and not by actual delivery. Loss from this head can not be set off against any other head of income but carried forward for 8 years.

From the above, it is clear that S .28 covers:

1 Business Income
2. Speculation income
3. Compensation for agency termination etc
4. Export incentives: cash assistance, duty drawback etc.
5. Fee from members
6. Partners' remuneration
7. Value of any benefit or perquisites like gifts.
8. Non-compete agreements
9. Keyman insurance policy.

3.3. Computation -S.29:

Business income computed by taking the income from all the sources specified in S. 28 in respect of a business / profession carried on by the assessee in the relevant previous year as reduced by the expenses and deductions laid down in S. 30 to 44D

A collective reading of the two sections brings out in focus the following essential characteristics and conditions:

1. There must be a business or profession.
2. Such business or profession must be carried on by the assessee
3. The business or profession must be carried out during the previous year.
4. If a business or profession is closed down the expenses can not be deducted.
5. Expenses will be allowed as a deduction from gross receipts only if they have been incurred in the relevant previous year.
6. Expenses incurred before setting of the business will not be allowed except where specifically provided by law.
7. The general methodology for determining taxable business or professional income is to deduct expenses incurred for earning the income from the gross income or gross receipts or gross sales and thereby derive the resultant profit is applicable subject to modifications given in S. 30 to 44D.

3.4. Method of Accounting:

Starting point of computation is the business profits computed in accordance with method of accounting regularly employed by the assessee. There are two main methods of accounting—mercantile system and cash system.

a. Mercantile system

Under the mercantile system of accounting, all the income and expenses are recorded on accrual basis. Actual receipt of incomes or actual payment of expenses during the year is not necessary. Net profit or loss is computed after considering all income and expenses, whether or not actually received or paid during the accounting period.

If assessee maintains the books of account according to the mercantile system, income of a business or profession, accrued during the previous year is taxable. The income may be received or expenditure may be paid during the previous year or in a year preceding or following the previous year.

b. Cash system

Under the cash system of accounting, a record is kept of actual receipts and actual payments of a particular year. Net profit under the cash system will be equal to difference of incomes received and expenses paid during the accounting year whether such receipts and payments relate to the previous year or some other year or years.

Illustration-1:

A actually earns Commission in the year 2010-11 but receives it in the year 2011-12. Mercantile system recognizes commission as the income in the year of accrual i.e. 2010-11 taxable in A.Y. 2011-12 although it is not actually received during that year.

Under the cash system, commission will be the income of the year of actual receipt i.e. 2011-12 taxable in A.Y. 2012-13 although it is was earned in the year 2010-11

4. DEDUCTIONS EXPRESSLY ALLOWED UNDER THE ACT- S.30-35

Section 30 to 35 expressly provide for deduction of certain expenses against profits and gains of business or profession. These expenses are allowed to all types of the assessees.

Section 30 allows deduction in respect of rent, rates, taxes, repairs & insurance for Building while S. 31 allows the expenses incurred on repairs & insurance of machinery, plant & furniture. Section 32 and 34 provides for deduction of depreciation on business assets. Section 35 deals with expenses incurred on scientific research. These provisions are explained in detail below:

4.1 Rent, Rates, Taxes, Repairs & Insurance for Building- S. 30:

U/s 30, the following expenses incurred in respect of the business premises are allowed to be deducted from the business income:

a. the rent of premises,
b. the cost of repairs borne by the assessee if the business premises is tenanted one ;
c. the cost of current repairs in respect of other premises occupied otherwise than as a tenant;
d. any sum paid on account of land revenue, local rates or municipal taxes subject to the provisions of section 43B and
e. Insurance premium paid against risk of damage or destruction of the premises.

Capital expenditure is not allowed as deduction in any of the above cases.

4.2 Repairs & Insurance of Machinery, Plant & Furniture – Sec. 31:

Section 31 allows deduction in respect of expenses incurred on current repairs and insurance in respect of plant, machinery and furniture used for business purposes.

Capital expenses are not allowed to be deducted under this section. Machinery hire charges are not covered under this section but as residual expenses u/s 37.

4.3. Depreciation - S.32:

S 32 deals with depreciation allowed as a deduction from business income. Determination of depreciation and other related matters are taken up for detail analysis in a separate chapter.

4.4. Expenditure on Scientific Research –S 35

Section 35 offers tax incentives for scientific research. According to S 43[4] scientific research" means "any activity for the extension of knowledge in the fields of natural or applied sciences including agriculture, animal husbandry or fisheries".

The provisions dealing with deduction in respect of scientific research are summarised as under:

A. Expenditure incurred by the assessee for own business sec. 35(1)(ii)/35[2]:

In case of in-house research 100% deduction will be allowed in respect of expenditure incurred by the assessee himself on scientific research on the following:

I. any Revenue expenditure or

II. any Capital Expenditure other than the cost of land or

III. expenses both capital and revenue excluding cost of land incurred up to _three years prior to the commencement of business_ including salaries of the research staff or research material used in scientific research . Such expenses are allowed as deduction in the previous year in which the business is commenced.

Such research must relate to the business. Expenses incurred _not related to assessee's own business will not be allowed_ as deduction under this section.

Illustration 2:

Expenses incurred during the financial years 2007-08 to 2009-10 will along with the expenses incurred during the previous year 2011-12 will be allowed as deduction in A.Y. 2012-13

Following other points are important:

1. Deduction is available even if the relevant asset is not put to use for research and development purposes during the previous year.

2. The expenses may be on plant or equipment for research or construction of building (excluding cost of land) for research or other expenses of capital nature connected with the research.

3. The 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 covered u/s 35

6. If a scientific research asset is sold, its sales price or amount allowed as deduction u/s 35, whichever is less, will be treated 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) will be treated as "Capital gains"._

Illustration 3:

A scientific research asset costing Rs. 5,00,000 purchased on 01/01/2008 is sold on 31/03/2012 for Rs. 7,00,000.

Entire cost of Rs. 5,00,000 will be allowed as deduction u/s 35 in A.Y. 2008-09. When the asset is sold in the previous year 2011-12, Rs 5,00,000 allowed as deduction earlier will be charged as business income and excess over the cost Rs. 2,00,000 will be chargeable as capital gain in the assessment year 2012-13.

B. Expenditure on in-house research and development expenses [SEC. 35(2AB)] :

A weighted deduction of **Twice** the expenditure incurred **(200%)** will be allowed to *a Company* engaged in "any business of manufacture or production of any article or thing, not being an article or thing specified in the list of the Eleventh Schedule in respect of expenditure on in-house research and development expenses incurred up to **March 31, 2012.** The expenditure may be capital or revenue but cost of land and building are not eligible for weighted deduction.

The deduction is subject to following conditions;

a. The research and development facility is approved by the prescribed authority.

b. The company has entered into an agreement of cooperation with the prescribed authority.

c. The Company gets audit of the accounts maintained for such a facility.

The items prohibited by schedule XI include:

- Beer, wine and other alcoholic spirits.
- Tobacco products like cigars and cheroots, cigarettes, biris, smoking mixtures for pipes and cigarettes, chewing tobacco and snuff.
- Cosmetics and toilet preparations.
- Tooth paste, dental cream, tooth powder and soap.
- Aerated waters
- Confectionery and chocolates.
- Gramophones, including record-players and gramophone
- Projectors
- Photographic apparatus and goods.
- Office machines and apparatus such as typewriters, calculating machines, cash registering machines, cheque writing machines, intercom machines and teleprinters (but NOT Computers .
- Steel furniture, whether made partly or wholly of steel
- Safes, strong boxes, cash and deed boxes and strong room doors.
- Latex foam sponge and polyurethane foam.
- Crown corks, or other fittings of cork

C. Contribution made to outsiders [sec. 35(1)(ii)/(iii)/352AA] :

A weighted deduction equal to **one and three fourth times (175%)** is allowed in respect of any sum paid to :

(i) a university, college or other institution to be used for research in social science or statistical research- **sec. 35(1)(ii]**

(ii) Approved and notified research association which has as its object undertaking of scientific research or to a university, college or other institution to be used for scientific research : - **sec. 35(1)(iii]**

(iii) National Laboratory; or University; or Indian Institute of Technology; or Specified person as approved by the prescribed authority for undertaking scientific research programme **sec. 35(2AA).(200% weighted deduction w.e.f 01-04-2012**

(iv) a company for scientific research if the company is registered in India with object of scientific research and development and is approved by the prescribed authority- **sec. 35(1)(iia).** however deduction in this case will be **125%** of the sum paid

Other points;

a. Scientific research carried on by such institute need not be related to the business of the assessee
b. Such contribution, which is eligible for weighted deduction, is not eligible for any other deduction under the Act.
c. A research association can be a university, college or other institution which has as its object undertaking of scientific research so long as it is approved and notified by the prescribed authority. Subsequently if such approval is withdrawn, it will not be a ground of denial of weighted deduction to the assessee.

4.5. Amortisation of Preliminary Expenses-S 35D

Section 35D provides for Amortisation of preliminary expenses over a period of years. These provisions are summarized below:

I. Eligible assessee;

Deduction in respect Preliminary expenses is available to of an Indian company or other a resident non-corporate assessee. A foreign company even if it is resident in India, cannot claim any deduction under section 35D.

II. Time and purpose of preliminary expenses –

Following expenses are qualified for deduction u/s 35D: —

1. Expenses for setting up any undertaking or business incurred **before** commencement of business or

2. Expenses incurred in connection with extension of an industrial undertaking or in connection with setting up **a new industrial** unit **after** commencement of business.

Deduction under section 35D is not available in respect of expenditure incurred after commencement of business if such expenditure is incurred in connection with extension of (or setting up) a non-industrial undertaking.

III. Eligible Expenditure:

Following expenses are eligible for deduction under this section:

a. 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)or
- engineering services related to the business of the assessee.

The above work must be carried out either by the assessee or a concern approved by the CBDT.

b. Legal charges for drafting any agreement for setting up or conduct of the business.

c. Legal charges for drafting the memorandum and articles of association.

d. Printing expenses of the memorandum and articles of association.

e. Registration fees of a company under the provisions of the Companies Act.

f. Expenses in connection with the public issue of shares or debentures of a company, underwriting commission, brokerage and charges for drafting, typing, printing and advertisement of the prospectus.

g. Any other prescribed expenditure.

IV. Qualifying Expenditure:

The aggregate expenditure cannot exceed the following—

In the case of a corporate assessee 5% of

a. cost of project; or

b. capital employed, whichever is more

In the case of a non-corporate assessee: 5 per cent of cost of project

Excess expenditure, if any will not be allowed as deduction.

V. Cost of project:

Cost of project means the aggregate of actual cost of fixed assets appearing in the in the books of the assessee as on the last day of the previous year in which the business of the assessee commences.

Fixed assets include land, buildings, leaseholds, plant, machinery, furniture, fittings and railway sidings (including expenditure on development of land and buildings),or additional cost incurred after commencement of business in connection with extension or setting up an industrial undertaking) of fixed assets,

VI. Capital employed in the business of a company –

Capital employed 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 or additional capital borrowings etc brought after commencement of business in connection with extension or setting up an industrial undertaking,

Long term borrowings for this purpose means moneys borrowed in India by any company from the Government or Financial institutions like ICICI, IFCI etc or banks or foreign borrowings in connection with acquisition of plant and machinery repayable after a term of seven years or more .

VII. 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.

VIII. Other Points:

1. Non- corporate assessees are required to get their account audited for claiming deduction under this section
2. On amalgamation/ demerger of the assessee company with other company, deductions can be claimed by the amalgamating or demerged company .
3. Amount deducted under this section will not be eligible for deduction under any other provision of the Act.

Illustration 4:

ABC Ltd , an existing Indian company engaged in developing and providing computer software services which sets up a new unit incurs the following expenditure in connection with the setting up of new unit. The project is completed in March,2012

Preparation of project report	Rs 2,00,000
Market Survey	Rs 6,00,000
Legal and other charges for issue for additional capital required for the new unit	Rs 3,00,000
Engineering Services by Blab Ltd not approved by CBDT u/s 35D)	Rs 5,00,000
Cost of the Project as on 31/03/2012	Rs 60,00,000
Capital employed in the new unit as on 31/03/2012	Rs 50,00,000

Determine the amount deduction admissible u/s 35D.

Solution:

A. Eligible Expenditure:

Preparation of project report	Rs 2,00,000
Market Survey	Rs 6,00,000
Legal & other charges for issue for additional capital required for the new unit	Rs 3,00,000
Engineering Services by Blab Ltd not approved by CBDT u/s 35D) Not Eligible	0
Total	Rs 11,00,000

B. Gross Qualifying Amount:

5% of the cost of the project (5% X 60,00,000)	Rs. 3,00,000
5% of the capital employed in the new unit (5% X 50,00,000)	Rs. 2,50,000
Amount qualifying for deduction U/s 35D the higher of the above two	Rs 3,00,000

C. Qualifying Amount:

Gross qualifying amount	Rs 3,00,000
Actual amount of preliminary expenses	Rs 11,00,000
Net qualifying amount Lower of the above	Rs 3,00,000

D: Amount of Deduction:
1/5th of the net qualifying amount = 1/5 X 3,00,000 = Rs 60,000 for each of the 5 assessment from A.Y. 2012-13 onwards

5. SPECIFIC DEDUCTIONS: - S. 36

S. 36(1) allows certain specific deductions from the business income: These deductions are summarised as follows:

5.1. Insurance Premium paid- S. 36(1)(I)/(1)(Ia)/ S. 36(1)(ib

- In respect of insurance against risk of damage or destruction of **stocks** or stores used for the purposes of the business or profession **- S. 36(1)(i)**
- by a federal milk co-operative society to effect or to keep in force an insurance on the **life of the cattle** owned by a member of a co-operative society, being a primary society engaged in supplying milk raised by its members to such federal milk co-operative society **- S. 36(1)(ia)**
- by cheque by the assessee as an employer to effect or to keep in force an insurance on the **health of his employees** under a scheme framed in this behalf by the General Insurance Corporation of India **- S. 36(1)(ib)**

5.2. Bonus or commission- S. 36(1)(ii):

Any sum paid to an employee as **bonus or commission** for services rendered, where such sum would not have been payable to him as profits or dividend if it had not been paid as bonus or commission. Bonus or commission is, however, allowed u/s 43B as deduction only where payment is made during the previous year or on or before the due date of furnishing return of income u/s139(1) of Income Tax Act, 1961.

5.3. Interest paid on capital borrowed - S. 36(1)(iii):

The amount of **the interest paid** in respect of capital borrowed for the purposes of the business or profession not being interest on amounts borrowed for acquisition of an asset for extension of existing business or profession (whether capitalised in the books of account or not); for any period beginning from the date on which the capital was borrowed for acquisition of the asset till the date on which such asset was first put to use. Recurring subscriptions paid periodically by shareholders, or subscribers in Mutual Benefit Societies which fulfill such conditions as may be prescribed, shall be deemed to be capital borrowed within the meaning of this clause.

This implies that

- Funds must be borrowed.
- Borrowing must be for the purposes of the business or profession
- Interest must be paid or payable on such funds,
- Interest on funds borrowed for expansion etc. is not allowed as deduction. Instead, interest may be treated as the actual cost of the asset and depreciation can be calculated accordingly.
- Contribution paid to benefit society is treated as part of the funds borrowed.

5.4. Discount on Zero Coupon Bonds- *S. 36(1)(iiia):*

Discount on notified (by Central Government) Zero Coupon Bonds issued by infrastructure capital company or infrastructure capital fund or a public sector company on or after 01/06/2005 is allowable on *pro rata* basis provided no other benefit or payment is received in respect of such bonds before their maturity.

Since these bonds are normally issued at a price lower than their redemption value, they are called Zero Coupon Bonds as there is no Coupon Rate of Interest. This difference or discount is allowed on *pro rata* basis having regard to the period of life i.e. date of issue to the date of maturity or redemption of such bonds. Simply speaking, discount on Zero Coupon is amortised over the life time of the Bonds.

Illustration 5:

Infrastructure Capital Company issues 1 Crore duly notified Zero Coupon Bonds of Rs. 1000 each at a price of Rs. 640 on 01/01/2009. The bonds are redeemable at par on 31/12/2010. Show how the discount would be deducted from the total income of the company.

Solution:

The total discount offered on Zero Bond Coupon is Rs. 360 Crore i.e. I Crore X (Rs. 1000-640). The tenure of the coupon is three years or 36 months.

Pro rata deduction allowed for three months 30 Crores [Rs. 360 Crore X 3/36] in AY 2009-10 , Rs. 120 Crores each for AY 2010-11 and 2011-12 and balance Rs. 90 Crores in A.Y. 2012-13.

5.5. Contribution towards a recognised provident fund/ approved superannuation Fund *-S. 36(1)(iv):* :

Any sum paid by the assessee as an employer by way of contribution towards a recognised provident fund or an approved superannuation fund, subject prescribed limits and conditions and also subject to the provisions of S 43B.

5.6. Contribution towards an approved gratuity fund- *S. 36(1)(v):*

Any sum paid by the assessee as an employer by way of contribution towards an approved gratuity fund created by him for the exclusive benefit of his employees under an irrevocable trust;

5.7. Employee's Contribution towards PF/ ESIC etc.-S. 36(1)(va):

Contribution received by an employer from his employees for crediting in any fund (e.g. PF/ESIC etc covered u/s 2[24][x] and credited by the assessee to the Employees' account in the

relevant fund or funds on or before the due date prescribed under the relevant law .

Net effect of the provisions read with S. 43B is that such contributions are treated as income at first and when paid by the due date are allowed as deductions If however, the contribution is not paid in time, it will not be allowed as a deduction and effectively considered as the income of the employer even of it is paid later.

5.8. Death of animals-- S. 36(1)(vi):

In respect of animals which have been used for the purposes of the business or profession otherwise than as stock-in-trade and have died or become permanently useless for such purposes, the difference between the actual cost to the assessee of the animals and the amount, if any, realised in respect of the carcasses or animals;

Where the animals are treated as stock in trade, the loss or profit is the part of normal sales and purchase, therefore this provision is not applicable.

5.9. Bad debts-- S. 36(1)(vii):;

Any amount of bad debt or part thereof which is written off as irrecoverable in the accounts of the assessee for the previous year: It is subject to certain conditions laid down in this section 36(2) namely:-

- any bad debt or part thereof written off as irrecoverable in the accounts of the assessee shall **not include any provision** for bad and doubtful debts made in the accounts of the assessee;
- no such deduction shall be allowed unless such debt or part thereof has been taken into account in computing the income of the assessee of the previous year in which the amount of such debt or part thereof is written off or of an earlier previous year, or represents money lent in the ordinary course of the business of banking or money-lending which is carried on by the assessee;
- if the amount ultimately recovered on any such debt or part of debt is less than the difference between the debt or part and the amount so deducted, the deficiency shall be deductible in the previous year in which the ultimate recovery is made;
- any such debt or part of debt may be deducted if it has already been written off as irrecoverable in the accounts of an earlier previous year but the Assessing Officer had not allowed it to be deducted on the ground that it had not been established to have become a bad debt in that year;

- where any such debt or part of debt is written off as irrecoverable in the accounts of the previous year and the Assessing Officer is satisfied that such debt or part became a bad debt in any earlier previous year not falling beyond a period of four previous years immediately preceding the previous year in which such debt or part is written off, the provisions of sub-section (6) of section 155 shall apply;

5.10. Provision for bad and doubtful debts created by banks etc.-- S. 36(1)(viia):

Any provision for bad and doubtful debts upto:

- seven and one-half per cent of the total income by a scheduled Indian bank other non-scheduled bank,
- five per cent of total income a public financial institution or a State financial corporation or a State industrial investment corporation and a foreign bank of the total income (computed before making any deduction under this clause and Chapter VI-A) and
- ten per cent of the aggregate average advances made by the rural branches of such bank computed in the prescribed manner, and subject to certain conditions or
- at the option of such bank what is known as NPA (Non Performing Assets) in accordance with the RBI guidelines upto 5% of such assets shown in the books of account of the bank on the last day of the previous year a bank,
- The deduction is subject to two conditions :

-Assessee has debited the amount of such debt or part of debt in that previous year to the provision for bad and doubtful debts account made under that clause and

-Deduction relating to any such debt or part thereof shall be limited to the amount by which such debt or part thereof exceeds the credit balance in the provision for bad and doubtful debts account made under that clause.

5.11. Special reserve-- S. 36(1)(viii):

Any special reserve created and maintained by a financial corporation which is engaged in providing long-term finance for industrial or agricultural development or development of infrastructure facility in India or by a public company formed and registered in India with the main object of carrying on the business of providing long-term finance for construction or purchase of houses in India for residential purposes, **an amount not exceeding forty per cent** of the profits derived from such business of providing long-term finance computed under the head Profits and gains of business or profession before making any deduction under this clause carried to such reserve account

subject to a ceiling of twice the amount of the paid-up share capital and of the general reserves.

5.12. Promotion of family planning among the employees- S. 36(1) (ix):

Any expenditure *bonafide* incurred by a company for the purpose of promoting family planning amongst its employees and where such expenditure or any part thereof is of a capital nature, **one-fifth** of such expenditure shall be deducted for the previous year in which it was incurred; and the balance thereof shall be deducted in equal instalments for each of the four immediately succeeding previous years: Further unabsorbed family planning will be allowed to be carried forward and set off in the same manner as depreciation.

5.13. Exchange Risk- S. 36(1)(x):

Any sum paid by a public financial institution by way of contribution towards any Exchange Risk Administration Fund set up by public financial institutions, either jointly or separately.

5.14. Contribution to Pension Fund

Any sum paid by way of contributions by employer to a pension scheme referred to in Section 80CCD(2) on account of employee to the extent of 10%, deductible **with effect from 1st April 2012.**

6. GENERAL DEDUCTIONS/ RESIDUARY PROVISIONS – S. 37:

U/s 37 (1) Any expenditure (not being expenditure of the nature described in sections 30 to 36 and not being in the nature of capital expenditure or personal expenses of the assessee), laid out or expended wholly and exclusively for the purposes of the business or profession shall be allowed in computing the income chargeable under the head Profits and gains of business or profession. Further any expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law shall not be deemed to have been incurred for the purpose of business or profession and no deduction or allowance shall be made in respect of such expenditure. No allowance shall be made in respect of expenditure incurred by an assessee on advertisement in any souvenir, brochure, tract, pamphlet or the like published by a political party – S. 37(2B).

An analysis of the section will indicate that all expenses which are not covered by any other section will be allowed as a deduction under section 37 provided the following conditions are satisfied namely:-

1. The expenses are **not covered** specifically under the provisions of section 30 to 36.

2. The expenses are **not personal** in the nature. Personal income tax, wealth tax, drawings, etc are held to be personal in nature
3. The expenses are **not in the nature of capital** expenditure. Thus expenses for acquiring fixed assets, or renovation thereof, conveyance of land, expenses for eviction of a tenant etc are some examples of capital expenses not allowable.
4. The expenses are incurred **wholly and exclusively for** the purpose of **such business**.
5. Such expenses should be incurred in the **previous year** only.
6. The expense should be in respect of a business carried on by the assessee and the profits of which are to be computed and assessed and should be incurred after the business set up.
7. Any illegal expenses are not allowed. Thus penalty, bribery, composition money paid in respect of any offences or breach of law, and even penal interest is held to be not allowable under this section.
8. Political advertisements have been specifically excluded from the purview of the section.
9. All the expenses whether by way of cost of raw materials, tools, spares etc, cost of labour, salary , brokerage, commission, legal fees, litigation expenses, professional tax, trade mark registration , lease rent etc and various expenses incurred by the assessee will be allowed to be deducted under this section.

7. SPECIFIC DISALLOWANCES– S.40-40A-43B

Some expenses are expressly disallowed by law. In respect of some of the expenses, the disallowance is made simply because the expenses do not fit into the framework of legal conditionality. For instance S. 37 allows all the expenses which are not personal or which are not of capital in nature. Obviously all personal and capital expenses will not be allowed.

Similarly, S. 37(2B) provides that any expenditure incurred by way of advertisement expenses for giving an advertisement in any publication of a political party will not be allowed as deduction. Sections 40, 40A and 43B expressly disallow some expenses while computing income chargeable under the head “Profits and gains of business or profession”. Some disallowances are absolute and others are conditional like default in deduction of tax at source notwithstanding anything to the contrary in sections 30 to 38.

Theses disallowances are discussed below.

7.1. DISALLOWANCE IN THE CASE OF ANY ASSESSEE – S. 40

i) Interest, Royalty, Fees for Technical Services payable to a **Non-Resident** [S. 40(a)(i)]

Any interest, royalty or fees paid for technical services chargeable to tax under the Income Tax Act which is payable outside India, if tax -

-has not been deducted on those amounts or

-has been deducted at source but not paid during the previous year or in the subsequent year before the prescribed time (April 30).

If however at a later date, tax on such amounts is paid or deducted at source such amounts will be allowed as deduction in the year in which the tax has been paid or deducted

ii) Payments made to residents without TDS [S.40(a) (ia)]

Any **interest, commission or brokerage, rent, royalty fees for professional services or fees for technical services** payable to a **resident**, or amounts payable to a **contractor or sub-contractor**, being resident, for carrying out any work (including supply of labour for carrying out any work), on which tax is deductible at source if tax:

-has not been deducted on those amounts or

-has been deducted at source but not paid

has not been paid on or before the due date specified in sub-section (1) of section 139 .

In other words if the TDS payment is made before the due date of fling the return , it will be allowed but if tax is not deducted at all the sum will not be allowed as deduction in that year. If however at a later date, tax on such amounts is paid or deducted at source such amounts will be allowed as deduction in the year in which the tax has been paid or deducted.

iii) Any sum paid on account of securities transaction tax [S. 40(a)(ib)]:

iv) Any sum paid on account of any rate or tax levied on the profits or gains of any business or profession or assessed at a proportion of, or otherwise on the basis of, any such profits or gains such as Income Tax, interest and penalty; Fringe Benefit Tax etc [S. 40(a) (ii)]

vi) Any sum paid on account of **wealth-tax**. [S. 40(a) (iia)]

vii) Salary payable outside India; or to a non-resident, and if the tax has not been deducted or deducted and has not been paid therefrom under Chapter XVII-B.

However such salaries will be allowed as a deduction in the year in which the tax has been paid in respect of the salary. [S. 40(a) (iii)]

viii) Any payment to a provident or other fund established for the benefit of employees of the assessee, unless the assessee has 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. Such payment will not be allowed as a deduction if tax has not been deducted in the year in which such payments have been made. However these payments will be allowed as a deduction in the year in which tax has been paid.[S.40(a) (iv)]

ix) Any tax actually paid by an employer on perquisites u/s10 (10CC)-[S. 40(a) (v)]

Illustration- 6.

Commission of Rs. 1,50,000 has been paid to a Non-Resident for the previous year 2011-12. Tax to be deducted is Rs. 35,000 and due date for payment is 30/06/2011.

Discuss the allowability of commission in each of the following situations.-

a) The assessee has not deducted tax at source at all,,

b) The assessee has duly deducted tax at source but not paid the same to the Government in time.

c) The assessee has duly deducted tax at source and paid the same to the Government.

d) The assessee has paid the tax to Government after deducting the same in December, 2011.

Solution:

(a) & (b) Commission will be disallowed u/s 40(a) (i).

(c) Commission will be allowed as a deduction in assessment year 2012-13

(d), commission will be allowed as a deduction in assessment year 2012-13

7.2. DISALLOWANCES IN THE CASE OF ANY FIRMS- S.40

i) **Disallowance of Remuneration to Partners– S. 40(b)**

(i) Any payment of remuneration, to any partner who is **not a working partner**; or

(ii) any payment of remuneration to any partner who is a **working partner**, which, in either case, is **not authorised** by, or is not in accordance with, the terms of the partnership deed; or

(iii) Remuneration, to working partner though authorised, relating to any period falling **prior to the date of such partnership deed** or

(iv) Remuneration, to working partner though authorised and otherwise allowable, if the remuneration to all partners in aggregate exceeds the following limits:

Book Profits	Remuneration allowable
(a)on the first Rs. 3,00,000 of the book profit or in case of a loss	Rs.1,50,000 or 90 % of the book-profit, whichever is more;
(b) on the balance of the book-profit	60 % of the book profits

"Book-profit "means the net profit, as shown in the profit and loss account for the relevant previous year, computed in the manner laid down in Chapter IV-D as increased by the aggregate amount of the remuneration paid or payable to all the partners of the firm if such amount has been deducted while computing the net profit. In other words Book Profit means net profit before providing for remuneration to partners.

"Working partner" means an individual who is actively engaged in conducting the affairs of the business or profession of the firm of which he is a partner.

A non-working partner is one who is not a working partner.
"Remuneration means "any payment of salary, bonus, commission or remuneration by whatever name called.

ii) **Disallowance of Interest to Partners-S. 40(b)**

(i) Any payment of **interest to** any partner which is **not authorised by** or is not in accordance with, the terms of the partnership deed; or

(ii) Interest, to partner thought authorised, relating to any **period falling prior to the date** of such partnership deed or

(iii) Interest in accordance with the deed of partnership but in excess of the amount calculated at the rate of twelve per cent simple interest per annum;

Following points should be kept in mind:

- A partnership deed may, at any time during the said previous year be amended to provide for payment of interest but such amendment will be applicable only prospectively. Retrospective effect can not be given to such terms.

- The interest will be taken into account in the same capacity in which it is paid. For instance, A is a partner in his capacity of a trustee of B, interest payable to A in his capacity of trustee alone will be considered. Interest paid in his individual capacity will be ignored. On the other hand, if A is a partner in individual capacity ,interest paid to him in his representative capacity shall be ignored.

Illustration-7:

Net Profit of a firm is Rs 50,000 after debiting the following amounts:

a) Salary to A, who is not a working partner Rs. 50000

b) Salary to B who is a working partner Rs. 5,00,000 for the whole year from 01/04/2011 to 31/03/2012. The remuneration was provided by the deed dated 01/7/2011

c) Interest to partners @ 18% Rs. 90,000. Correct interest payable works out to Rs.72,000

Compute the business profits for the assessment year 2012-13.

Solution:

Computation of Profits from Business for A.Y. 2012-13

Particulars			Rupees
Business Profits as per P/L A/c			50,000
Add: Salaries & Interest paid to partners (50,000+5,00,000+90,000)			6,40,000
Book Profits before interest & remuneration			6,90,000
Less: Interest authorised by partnership deed restricted to 12% i.e. 72000 X 12/18			48,000
Book Profit Before Remuneration			6,52,000
A's Remuneration as he is not a working partner		NIL	
B's Remuneration (Lowest of the following) 1. Actual 2. From the date of deed 01/7/2011 to 31/03/2012 9 months- 500000 X 9/12] 3. <u>Maximum allowable :</u> 90% of first Rs 3,00,000 2,70,000 Plus 60% of Balance Rs. 3,52,000 – 2,11,200	 5,00,000 3,75,000 4,81,200	3,75,000	3,75,000
Profits from Business			2,77,000

7.3. DISALLOWANCES OF REMUNERATION/ INTEREST IN THE CASE OF ANY AOP/BOI-S. 40(BA)

Any payment of interest, salary, bonus, commission or remuneration, by whatever name called, made by such association or body to a member of such association or body.

"AOP/BOI do not include a company or a co-operative society or a society registered under the Societies Registration Act, 1860, or other registered charitable trusts).

Following points are noteworthy:

1. The capacity of the member will be considered in the same manner as firm.
2. If interest is paid to a member on funds borrowed by him, the disallowances will be only on the net amount receivable by such members.
3. Disallowance in case of AOP/BOI is total unlike the firms, where the disallowance is partial and conditional. As a result, remuneration or interest to members of AOP/BOI is not allowed to be deducted for computing income from business and profession.

Illustration-8:
X is a member of BOI. X borrows a sum of Rs. 1,00,000 from market with interest rate of 12% and advances it to the BOI. A BOI pays Interest @ 15% p. a to X. Determine the amount to be disallowed.

Solution:
BOI has paid Rs 15,000 to X as interest being 15% of Rs. 1,00,000. X in turn has paid interest of Rs 12,000 being 12% on Rs. 1,00,000 on the funds borrowed by him . Disallowance of interest U/s 40(ba) will be limited to Rs. 3,000 being the net interest paid to X [15000-12,000].

7.4. DISALLOWANCES IN THE CASE OF ALL ASSESSES –Sec -40A

S. 40A provides for disallowance of certain expenses in certain circumstances like cash payments of Rs. 20,000 or more excessive payment to relatives etc mainly as anti avoidance measures. Theses disallowances are overriding in nature and prevail even if normally such expenses should have been allowed.

i) Excessive payment to relatives -S. 40A (2):

Any expenditure resulting in any payment to any specified person will be disallowed to the extent it is excessive or unreasonable in the opinion of the assessing officer, having regard to the market value of the goods or services and the benefit to the business or profession. The specified persons include the following:-

A. Persons connected with the assessee	
Class of assessee	**Specified person**
Individual	any relative of the assessee;
Company	any director of the company
Firm	any partner of the firm
Association of Persons	any member of the association
Hindu Undivided Family	any member of the family
Any relative of such director, partner or member	
B. Sister concerns	
Person holding a substantial interest in the business or profession of the assessee	Specified person
Individual	Individual
Company	any director of the company
Firm	any partner of the firm
Association of Persons	any member of the association
Hindu Undivided Family	any member of the family
Any relative of such individual director, partner or member	

D : Reverse connection :

Where assessee or his relatives, or if the assessee is a company, firm, HUF ,AOP its directors , members or partners etc or their relatives), hold substantial interest in the business of other individual, company, firm, AOP or HUF . the latter will be treated as the specified persons .

"**Relative"** in this context means husband, wife, and brother, sister or any lineal ascendant or descendent of the individual.

A person holding "**Substantial interest"** means a person holding 20% voting power in a company at any time during the previous year or twenty per cent of the profits of other concern viz proprietary concern, HUF, AOP, BOI etc.

Illustrations 9:

Determine the specified persons u/s 40A (2)

a. A is an individual. His wife is a specified person
b. A is a firm having B,C and D is as partners , B ,C, D and their relatives will be the specified persons
c. If A is a HUF with B, C, and D as members, B ,C, D and their relatives will be the specified persons
d. If A is a AOP with B, C, and D as members, B ,C, D and their relatives will be the specified persons
e. If A is a Company with B, C, and D as directors, B, C, D and their relatives will be the specified persons.
f. In the above cases B is a company, then B and all directors of B will be the specified persons.
g. If C is a firm, then C and all partners of C will be the specified persons If D is A HIF or AOP, all the members as well as D will be the specified persons.

ii) Payments exceeding Rs 20,000 /35,000 other than by way of crossed cheque or demand draft – S. 40A(3).

Where in respect of any expenditure, payment exceeding Rs. 20,000 (Rs. 35,000 in cases of payments made for plying, hiring or leasing goods carriages) during a single day is made otherwise than by way of crossed bank cheque or draft; **whole** of this expenditure will be disallowed.

Following points require attention:

1. The disallowance is on total payment if it crosses the limit of Rs. 20,000 or Rs. 35,000 i.e on payments of Rs 20,001 (or 35,001) and more .
2. Limit of Rs. 20,000 or Rs. 35,000 will be considered with reference to the aggregate of all the payments made in a single day.
3. If expenditure is allowed in past on the basis of its accrual and subsequently cash payment is made in respect of such liability, in excess of Rs. 20,000 or Rs. 35,000 , such excess payment will be deemed to be the business profit in the year of payment.
4. However, Rule 6D provides some case where, no disallowance will be made even if the payment exceeds Rs 20,000 and is made otherwise than by way of crossed cheque or crossed bank draft some of theses circumstances are: new buyer, bank holiday, lack of banking facility, etc.
5. S 40A (4) forbids a person to raise an issue in a suit for being offered payment by account payee cheque or draft and not in cash.

Illustration-10:

Audit fee provided in A.Y. 2002-03 for Rs. 50,000 is paid by cash on 31.03.2012.

Solution

Rs. 50,000 will be deemed be the profit of the A.Y. 2012-13

Illustration-11:

A makes a payment of Rs. 25,000 by a bearer cheque for purchase of goods and claims that disallowance u/s 40A(3) is not applicable and even if it is applicable, it will be restricted only on Rs. 5,000 being , the amount exceeding Rs. 20,000. Examine his claim.

Solution

Disallowance will be made in respect of total payment of Rs. 25,000. Rs. 20,000 is not a basic limit as such. Once the payment limit crosses Rs. 20,000 , whole of the cash payment will be disallowed. Payment has to be made by crossed cheque or draft not bearer cheque.

iii) Provision for Gratuity-S. 40A (7)

No deduction shall be allowed in respect of any provision made by the assessee for the payment of gratuity to his employees on their retirement or on termination of their employment for any reason except any provision made by the assessee for the purpose of payment of a sum by way of any contribution towards an approved gratuity fund, or for the purpose of payment of any gratuity, that has become payable during the previous year. Thus gratuity will be allowed only when it has become due and payable. But once the provision for gratuity has been allowed as deduction in any year, then subsequent payment of gratuity will not be deductible again..

iv) Provision for non statutory funds -S.40A (9):

No deduction shall be allowed in respect of any sum paid by the assessee as an employer towards the setting up or formation of, or as contribution to, any fund, trust, company, association of persons, body of individuals, society or other institution for any purpose, except where such sum is so paid, for the purposes and to the extent provided by or under S. 36(1)(iv)/ (v) or as required by or under any other law for the time being in force like approved provident/gratuity funds , pension fund etc. However *bonafide* expenditure out of such fund may be allowed if actually spent S.40 (10). Further U/s S.40 (11) assessee will be entitled to receive back the unutilised part of any such fund/assets

8. DISALLOWANCES IN RESPECT OF CERTAIN UNPAID LIABILITIES-SEC. 43B

Section 43B is applicable only if the taxpayer maintains books of account on the basis of mercantile system of accounting. The section provides an exception to the mercantile system of accounting and provides for deduction of taxes and other statutory dues on cash basis.

U/s 43B, following expenses shall be allowed in the **previous year in which such sum is actually paid** (irrespective of the previous year in which the liability to pay such sum was incurred by the assessee according to the method of accounting regularly employed by him)

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

(b) any sum payable by the assessee as an employer by way of contribution to any provident fund or superannuation fund or gratuity fund or any other fund for the welfare of employees, or

(c) any sum referred to in S.36 (1)(ii) i.e. Bonus or commission to employees or

(d) any sum payable by the assessee as interest on any loan or borrowing from any public financial institutions i.e. ICICI, IFCI, UTI, IDBI LIC or a State financial corporation or a State industrial investment corporation], in accordance with the terms and conditions of the agreement governing such loan or borrowing , or financial arrangement or

(e) any sum payable by the assessee as interest on any loan or advances from a scheduled bank in accordance with the terms and conditions of the agreement governing such loan or advances,

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

The section provides an exception if the following two conditions are satisfied—

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

In other words, S 43B relies upon on cash system of accounting for payments of certain expenses except in case of an assessee, whose books are maintained according to the mercantile system and who satisfies the above two conditions. In that case, the expenditure will be deductible on “accrual” basis .

Following table summarises the position:

Date of Payment	Year of Deduction
During the year in the year of its accrual	year of payment or accrual as both are same
after the end of the year in which it is accrued but on or before the due date of submission of return of income for that year and the proof of deposit is submitted along with the return of income	year of accrual
Any other time not covered above or proof not attached with return	Year of payment

Illustration-12:

ABC Limited pays Sales Tax for the financial year 2011-12 before 30/09/2012. Determine the assessment year in which the sales tax may be claimed as deduction.

Solution

Due date for filling return of income by a company assessee for the assessment year 2012-13 is 30/09/2012. As the tax is paid before the due date, it will be allowed on accrual basis in A.Y. 2012-13.

Illustration-13:

ABC Ltd pays the Excise Duty for the previous year 2011-12 on 01/10/2011, in which assessment year will it be allowed ?

Solution;

ABC Ltd. pays tax after the due date for filling return of income , deduction will be allowed only in the year of actual payment year 2012-13 relevant to A.Y. 2013-14 .

Illustration -14

X Ltd. Has made the following payment of excise duty for the financial year 2011-12 .

S.No.	Date of payment	Rupees
1	2/5/2011	25,000
2	20/07/2011	65,000
3	16/8/2011	80,000
4	5/12/2011	20,000
5	12/06/2012	40,000
6	2/12/2012	10,000
7	Unpaid	10,000
	Total	2,50,000

Determine the year in which the excise duty will be deducted from the business profits.

Solution

- First four payments due and paid in the same year 2011-12 will be allowed as deduction in A.Y. 2012-13
- Rs. 40,000 paid on 12/06/2012 paid before the due date of filing return will be allowed as deduction in A.Y. 2012-13 if that the proof of payment is furnished along with the return of income .
- Rs. 10,000 paid on 02/12/2012 is paid after the due date for filing of return for A.Y. 2012-13 will be allowed in the year of payment ie. A.Y.2013-14.
- Unpaid amount of Rs. 10,000 will not be allowed as deduction until it is actually paid.

9. ILLUSTRATIONS:

Illustration -15

Profit and Loss Account of ABC & Co. for the year ending March 31, 2012 is as follows:

To Expenses	150,000	Professional Receipts	380,000
To Depreciation	20,000		
To Remuneration to partners	150,000	By Other fees	90,000
Interest on Capital to partners @ 20 per cent	20,000		
To Net Profit	130000		
Total	**360000**		**470000**

Other Information:

1. Expenses include Rs. 18,000 and Rs. 12,000 paid in cash as brokerage to a single party on a single day .
2. Depreciation calculated as per section 32 is Rs. 40,000

Compute the total income of the firm.

Solution

Computation of Total Income of AB C & Co. for A. Y. 2012-13

Particulars		Rs.
Net profit as per profit and loss account		1,30,000
Add: Expenses not allowable		
40A(3)- Cash payments to a broker exceeding Rs. 20,000	30,000	
Excess interest on capital to partners (20%-12%) i.e. 20000*8/20	8,000	38,000
		1,68,000
Less: Depreciation u/s32 (Rs 40,000-Rs 20,000 debited in profit and loss account)		20,000
		1,48,000
Add: Remuneration to partners debited to profit and loss account		1,50,000
Book Profit		2,98,000
Maximum permissible remuneration(lower of the two : (i.e 90 per cent of Rs 2,98,000 2,68,200 Actual 1,50,000		1,50,000
Business Income of the Firm		1,48,000

Illustration -16

Following is the Trading and Profit & Loss A/c of a firm consisting of A & B as the partners.

Trading and Profit & Loss A/c for the year ended 31st March, 2012.

Particulars	Rs.	Particulars	Rs.
To Opening Stock	75,000	By Sales	20,00,000
To Purchases	15,00,000	By Closing Stock	85,000
To Gross Profit	5,10,000		
Total	20,85,000	**Total**	20,85,000

To Salaries	2,50,000	By Gross Profit	5,10,000
To Sales Commission	40,000		
To Sales Tax	35,000	By Bad Debts Recovery	25,000
To General Expenses	5,000		
Advance Income Tax	54,000		
To Interest on Loan	42,000		
To Interest on Capital	18,000		
To Depreciation on Furniture & Fittings	4,000		
To Advertisement	16,000		
To Free Distribution of Samples	3,000		
To Insurance premium on Life of Partners	8,500		
To Printing & Stationery	3,500		
To Net Profit	56,000		
Total	5,35,000	**Total**	5,35,000

Additional information:

1. Salaries include Rs. 40,000 paid to partners, as per partnership deed and well within the limits u/s 40(b).
2. General Expenses are incurred for the purposes of pleasure tour of partners with their family members to Goa.
3. Income Tax paid includes Rs. 14,000 paid as tax on behalf of partners.
4. Bad Debts recovered were earlier allowed as a deduction.
5. Interest on Capital to partners is in excess of limits specified u/s 40(b) by Rs. 1,500 but as per partnership deed.
6. Cash expenses v for carriage of Rs. 40,000 in excess of Rs. 35,000

Compute the taxable income of the firm for the assessment year 2012-13.

SOLUTION:

Computation of Total Income of X & Y Co. for A.Y. 2012-13.		
Particulars	**Rs.**	**Rs.**
Profit as per Profit and Loss Account		56,000
Add: Expenses either disallowed or considered separately		
Salaries to Partners	40,000	
General Expenses incurred for personal purpose by the partners	5,000	
Cash expenses 40A(3)	40,000	
Income Tax (Advance)	54,000	
Interest on Capital	18,000	
Insurance on Life of Partners	8,500	1,65,500
		2,21,500
Less: Interest to partners (18000-1500)		16,500
Book Profit		2,05,000
Less: Salaries to partners		40,000
Business income		1,65,000

10. SELF-EXAMINATION QUESTIONS:

1) Define and explain the term "Business" as per the Income Tax Act, 1961.
2) Explain any six deductions which are specifically allowed as a deduction while computing income from business or profession and explain briefly any two of them.
3) What are the incomes chargeable under the head "Profits and Gains of Business or Profession"?
4) Enumerate eight items and discuss any three items of expenses which are expressly not allowed as deductions while computing income from "Profits and Gains of Business and Profession" under Income Tax Act, 1961.
5) "Section 37(1) is a residuary section while computing Profits and Gains of Business or Profession." Explain and discuss the conditions to be satisfied in order to claim deduction under Section 37(1).

6) Enumerate deductions allowed on payment basis under Section 43B and discuss any 2 of them in detail.

7) State the disallowance under Section 40A (3) if a purchase bill of Rs 45,000 was immediately paid by cash *(Ans: Rs. 45,000)*

8) State whether following expenses are allowed as a deduction or not while computing income from business or profession, if not, give reasons:

   a. Interest paid outside India wherefrom no tax has been deducted nor there is any representative assessee.
   b. Income tax paid by the firm.
   c. Salary paid outside India wherefrom no tax has been deducted nor there is any representative assessee.
   d. Salary paid to a partner.
   e. Guest House expenses.
   f. Advertisement expenses.
   g. Contribution to Gratuity Fund.
   h. Interest on borrowed capital.

   (Ans: Item f & h only allowable, d allowed subject to book profits)

9) Discuss the admissibility and/ or inadmissibility of the following expenditure under the Provision of Income Tax Act, 1961

a. A technical consultant was paid consultancy fee of Rs. 20,000 in cash by assessee and a deduction was claimed towards the expenditure.

b. A senior advocate conducted the Income tax proceeding before the Income Tax authority and was paid Rs 18,000/-

c. Provision made for gratuity as per actuary valuation of Rs 1,00,000/-

d. A sum of Rs 1,30,000/- was provided towards sales tax liability in the account for the year ending 31.3.2006

e. Stock-in-trade was lost to fire amounting to Rs 10,000/- and was debited to Profit and Loss Account. *(a,b & e allowable*)

10. Discuss the implication of the following transactions in the case of a doctor running a nursing home:

   1. Amounts received from the employees of the nursing home as contribution towards Provident Fund for the month of March 2011 paid to the PF - Rs 25,000 in December 2012
   2. Payment made in cash towards purchase in medicines –Rs 50,000

   (Ans.i) 25000 Income u/s/S 43 B/ Rs 50,000 disallowed

11. Are the following expenses allowable as deduction under section 37(1):

1. Litigation expenses for official purposes.
2. Expenses relating to purchase of stationary for official purpose.
3. Interest on loan taken for the purpose of paying income-tax.

(Ans; 1&2 allowable)

12. From the Profit and Loss Account of X for the year ending March 31, 2011, ascertain his total income for the assessment year 2012-13 :

Expenses	Rs.	Income	Rs.
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 exp.	7,000		
Contribution to RPF	13,000		
Net profit	1,60,600		
Total	4,12,600	Total	4,12,600

Other information:

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

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

(Ans:160600+21000+32000+23000+48000-37300+500 =247800)

9

DEPRECIATION
(Section 32)

Synopsis:

11. Introduction- & Objective
12. Conditions for claiming depreciation
13. Important Terms –Block, WDV , Actual Cost
14. Mode of computation
15. Succession of business
16. Depreciation to be allowed even if no claim made
17. Additional depreciation
18. Loss on sale of machinery
19. Unabsorbed depreciation
20. Self assessment questions

1. INTRODUCTION AND OBJECTIVES :

Depreciation is one of the most important deductions in computing the profits and gains from business and profession. S. 32 Income Tax Act enacts an independent code dealing with various aspects of depreciation, its determination, the conditions attached with the allowance and carry forward of the unabsorbed depreciation. This lesson will deal with all these aspects in detail.

2. CONDITIONS FOR CLAIMING DEPRECIATION:

Section 32 lays down the provision for determination and allowance of depreciation and the conditions for claiming the depreciation. Depreciation will be allowed only if these conditions are satisfied**.** The conditions are as follows:

a. Depreciation is allowed only in respect of **eligible depreciable assets and** such assets can be tangible or intangible.
b. The asset must be **owned** by the assessee or the assessee should be the co-owner of the asset.
c. It must be **used for** the purpose of **business** or profession.

d. It should be used during the relevant previous year.

Consequences when above conditions are satisfied –

The assessee, who satisfies the above four conditions viz **ownership** of **depreciable assets** put to **use for business** during the **previous year**, would be entitled to deduction in respect of depreciation whether or not the assessee has claimed the deduction for depreciation in computing his total income. Detailed description of the conditions is given below:

1. Types of the Assets – Tangible and Intangible

i. Assets eligible for depreciation :

Under Section 32 depreciation is allowable only on the following assets (depreciable assets) :

- buildings, machinery, plant or furniture, being tangible assets;
- know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, being intangible assets acquired on or after the 1st day of April, 1998.

"Building" means the superstructure only. It does not include site.

"Plant" includes ships, vehicle, books including technical know-how, scientific apparatus and surgical equipments used for the purpose of business or profession but does not include tea bushes or livestock or buildings or furniture and fittings.

ii. Assets not eligible for depreciation

Following assets are not eligible for depreciation:

(a) Foreign car acquired between 01-03-1975 and 31-03-2001 unless it is used
  - in a business of running it on hire for tourists ; or
  - outside India in his business or profession in another country ; and

(b) any machinery or plant if the actual cost thereof is allowed as a deduction in one or more years under an agreement entered into by the Central Government under Section 42.

2. Ownership – Partial ownership

Depreciable assets shall be wholly or partly owned by the assessee as owner or co-owner. Fractional or partial ownership is recognised for depreciation purpose. If an asset is owned in part by different assessees, each co-owner will be entitled to depreciation on his contribution to the cost of asset..

However, depreciation will be allowed on capital work, renovation or construction of any structure in building though **not owned** by the assessee is held on lease or other right of occupancy and the new structure is owned by the assessee
The courts have repeatedly taken the view that beneficial ownership is enough to claim the depreciation. Legal ownership is not necessary.

3. Purpose or User of the Assets

The asset must have been used for the purpose of business or profession of the assessee.

4. User of the Assets during the previous year

The depreciable asset must have been used for the purpose of business or profession of the assessee during the previous year. It is important because normal depreciation (full year's depreciation) is available if an asset is put to use at least for sometime during the previous year. Depreciation allowance is reduced to 50 per cent of normal depreciation, if -

a. an asset is acquired during the previous year; and
b. is put to use for the purpose of business or profession for less than 180 days during that year.

Courts have held that 50% depreciation is only in respect of asset acquired during the year and not other asset. A machinery bought for instance on March 30, 2010 but put to use only on January 1, 2011, would be eligible for 100% depreciation even though the actual usage of the machine has been less than 180 days. This is because the machinery would undergo wear and tear even if it was not put to actual use.

3. IMPORTANT TERMS :

a. Block Of Assets

U/s 2(11] - The term "block of assets" means a group of assets falling within a class of assets comprising of —

a) Tangible assets, being buildings, machinery, plant or furniture;

b) intangible assets, being know-how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of similar nature, in respect of which the same percentage of depreciation is prescribed.

It is important to note that:

- depreciable assets are first classified according to the group viz. building, plant, furniture or machinery ,

- each group is further classified according to the applicable rate of depreciation

Two assets of different groups e.g. temporary shed, books of professionals having same rate of depreciation viz. 100% will not form the part of the block.

b. Written Down Value (WDV)

i. Written down value of an asset means:

a. actual cost to the assessee of the asset acquired in the previous year, and

b. the actual cost to the assessee less all depreciation actually allowed thereafter

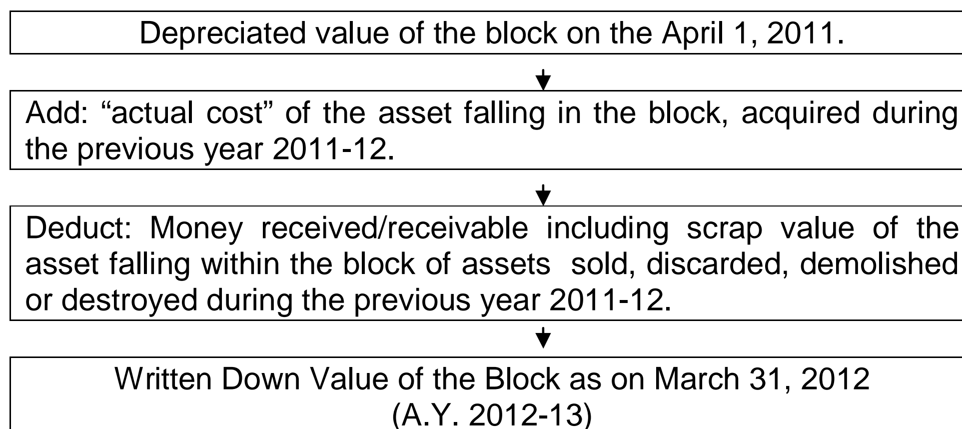
ii. Written down value of any block of assets, means the:

Opening WDV of the block (after 1-4-1988) or in case of slump sale, amalgamation, succession of business and demerger, conversion into company etc holding /subsidiary company opening value of the block of the previous owner or entity adjusted by:

a. **the increase** by the actual cost of any asset falling within that block, acquired during the previous year; and

b. **the reduction** of the moneys payable in respect of any asset falling within that block, which is sold or discarded or demolished or destroyed during that previous year together with the amount of the scrap value, if any, so, however, that the amount of such reduction does not exceed the written down value as so increased.

Following flow chart shows how WDV of a block for the A.Y. 2012-13 will be determined:



Important points to remember:

1. Any other things or benefit which can be converted in terms of money cannot be deducted

2. If the resultant block value figure is negative because the sale proceeds exceed the original block value plus increases, it will be treated as short term capital gain.

Illustration-1:

A Ltd has four assets depreciable @ 25 per cent. As on 1 April 2011 the value of these assets as per income tax records is 5,00,000. On 1 June 2011 the company purchases another asset depreciable @ 25 per cent for Rs 2,00,000 and sells an existing asset for Rs 4,00,000. Find out the WDV and depreciation of the block for the A.Y.2012-13

Solution:

	Rs.
WDV as on 1/4/2011	5,00,000
Add: Purchases	2,00,000
	7,00,000
Less: Sales	4,00,000
Adjusted Block	3,00,000
Depreciation @ 25 per cent	75,000
WDV of block as on 31 /3/2012	2,25,000

c. Actual Cost

Actual cost is determined on the following principles

i. Actual cost means the actual cost of the assets to the assessee, reduced by that portion of the cost thereof, if any, as has been met directly or indirectly by any other person or authority i.e. subsidy or grant and expenses incurred for acquiring the asset or installation thereof.
[Actual Cost – subsidy or grant]

Illustration 2:

A Purchases a machine for Rs 10 lakh with the non- refundable subsidy of Rs. 4 lakhs from SIDBI. Actual cost of the machine will be Rs. 6 lakh [Rs. 10 lakh-Rs 4 lakh].

ii. Actual cost of asset purchased for scientific research and brought into business use will be Actual Cost – Deduction available u/s 35.

Illustration 3:

A Purchases a machine for scientific research for Rs 10 lakhs with the non- refundable subsidy of Rs. 4 lakh from SIDBI. The machine is eligible for deduction u/s 35 to the extent of Rs. 3 lakh Actual

cost of the machine will be Rs. 3 lakh i.e. Rs. 10 lakh - Rs.4 lakhs Rs. 3 lakh

iii. Actual cost of asset acquired by way of gift or inheritance will be WDV to the previous owner

Illustration 4:
If A gifts away the machinery to B in the above illustration, the cost of machine to B will also be Rs. 3 lakh, which was the cost to A.

iv. Where the asset is acquired at an enhanced cost to claim more depreciation and reduce tax liability, actual cost of may be determined by the Assessing Officer. Actual cost of asset used and transferred earlier but now reacquired would be the old WDV or cost of repurchase whichever is less.

Illustration 5:
A sold a machinery for Rs. 3 lakh , when its WDV was Rs. 2 lakh and repurchased the same after two years at the then prevailing market value of Rs. 10 lakh . If the assessing officer comes to the conclusion that the machine is repurchased for getting more depreciation allowance on enhanced purchase value of Rs. 10 lakh, he can ignore it and allow depreciation only on Rs. 2 lakh.

4. MODE OF COMPUTATION

Following principles are important in computing the depreciation:

i. Depreciation is calculated on the WDV of the block after adjusting the sales and purchase during the year in the same block.

ii. Rates of depreciation for different assets are prescribed in rules.

iii. If WDV of any block of assets comes to Zero, depreciation will not be allowed on that block even if the assets in that block may be existing.

iv. If there are no assets left in any block of assets and the block become empty, or ceases to exist, no depreciation will be allowed on that block . WDV will be treated as short term loss.

v. If in the first year in which an asset is acquired, it is put to use for less than 180 days, depreciation will be allowed at 50% of the prescribed rates.

vi. **Straight Line Method (SLM)** method is applied in case of the assets of the power companies i.e. Undertakings engaged in generation or generation and distribution of power at the

prescribed rates of depreciation on the **actual cost** of the assets.

vii. Additional depreciation of 20% on actual cost in certain cases discussed later on in this lesson.

viii. No Depreciation will be allowed on foreign cars except in some case dealt with separately.

ix. Depreciation will not be allowed on scientific research assets , entire cost of which is allowed as deduction u/s 35.

5. SUCCESSION OF BUSINESS

When the business is taken over by a new entity e.g. conversion of a firm /sole proprietor to company (S. 47 –xiii/xiv), amalgamation, or demerger, or succession of business (S.170), ***succession of*** a private company or unlisted public company, by limited liability partnership S. 47 –xiiib, aggregate depreciation will not exceed during a previous year, the amount of depreciation had such event not taken place and such deduction shall be apportioned between the old and new entity

Illustration-6:
Under an scheme of amalgamation, A Ltd transfers to B Ltd, machinery having WDV of Rs. 3,65, 000 on 1/10/2011 . Rate of depreciation is 20%.
Calculate the depreciation in the hands of A Ltd. & B Ltd.

Solution:
If the amalgamation has not taken place, depreciation of Rs. 73,000 [20% on Rs. 3,65,000] would be allowed. The aggregate depreciation for the assessment year 2011-12 will not exceed this amount of Rs. 73,000 but allocated pro rata between A Ltd and B Ltd. in the ratio of the number of days for which the assets were used by them .

A Ltd held and used the asset for 183 days from 01-04-2011 to 30-09-2011 and B Ltd held and used it for 182 days from
01-10-2011 to 31-03-2012. The depreciation will be allowed in
in the ratio 183: 182
A Limited Rs. 36,600 ie 73,000*183days/365] and
B Limited Rs. 36,400 i.e. ie 73,000*182days/365

6. DEPRECIATION TO BE ALLOWED EVEN IF NO CLAIM MADE

The controversy whether depreciation has to be claimed or it can be simply allowed is now settled and explanation 5 makes it clear that the depreciation will be allowed whether or not the assessee has claimed the deduction in respect of depreciation in computing his total income

7. ADDITIONAL DEPRECIATION

Additional depreciation equal to 20% on the actual cost of any eligible new machinery or plant acquired and installed after the 31st day of March, 2008 by an assessee engaged in the business of manufacture or production of any article or thing.

The rate of depreciation will be 10% if the asset is used for a period of less than 180 days during the previous year,
Additional Depreciation will not be allowed in respect of the following assets;

a. Ships and aircrafts
b. Second hand machinery used by any other person in or out of India,
c. Machinery installed in a residential premises or a guesthouse
d. Any office appliances or road transport vehicles
e. Any plant or machinery, actual cost of which is already allowed as a deduction e.g. asset for scientific research.
f. buildings, furniture & fittings and old plant

8. LOSS ON SALE OF MACHINERY

When an asset is sold, discarded, demolished or destroyed in the previous year following rules apply:

a. If block has not become empty and the assets are still existing in the block and also some value is left in the block , sales proceeds/ scrap value will be deducted from the value of the block and depreciation will be allowed on the on the resultant value of the block after **increase by the actual cost** of assets acquired , if any

Illustration 7:
One of the assets from the block having WDV of Rs. 5 Lakh is sold for Rs. 1 Lakh; the resultant value of the block will be Rs. 4 Lakh. Assuming the depreciation at 30%, depreciation will be Rs. 1.20 Lakhs i.e. 30% of Rs . Rs. 4 Lakh

b. When the value of the block comes to zero,but assets are still existing and the block has not become empty, depreciation will not be allowed.

Illustration 8:
In the above example, supposing the asset is sold for Rs. 5 Lakhs, The resultant value of the block will be zero. Hence no depreciation will be allowed.

c. If the sale proceeds are more than the adjusted WDV of the block, the resultant surplus will be treated as Short Term Capital Gain regardless of the fact that assets are still left in the block or the block is empty.

Illustration 9:
In the above example, if the asset is sold for Rs 8 Lakh, surplus of Rs 3 lakhs will be taxed as short term capital gain.

d. If there are no assets in the block and the block becomes empty , and still WDV is not fully Witten off , there will be two consequences :

   i. There will be no depreciation allowance
   ii. Existing WDV will be treated as terminal loss or short term capital loss due to cessation of the block as result of sales,

Illustration 10:
In the above example, all the asset are sold for Rs 3 Lakh, Rs 2 lakh will be treated as short term capital loss as the block is empty. There will be no depreciation allowance.

e. When the depreciation is allowed on the **actual cost** / WDV of the assets of the undertakings engaged in generation or destitution of power called power companies, following rules will apply:

   - When such an asset viz any building, machinery, plant or furniture in respect of which depreciation is allowed , is sold, discarded, demolished or destroyed in the previous year not being the year in which it is first brought into use, terminal depreciation will be allowed.
   - Terminal depreciation is the deficiency or shortfall between the written down value and the sales proceeds / or moneys payable including scrap value, insurance, salvage or compensation moneys payable in respect thereof.
   - Terminal depreciation is not allowed in the year in which it was first brought to use.

- Such deficiency must be actually written off in the books of the assessee.
- Any surplus, arising therefrom is called the balancing charge and taxed as income u/s 43.
- Any moneys received over and above the depreciation allowed will be treated as capital gains.(s. 50A)
- In respect of some motor cars the actual cost was allowed only upto Rs. twenty-five thousand rupees, although the actual cost may be higher. In such a case actual cost/deficiency will be taken proportionately in the ratio of actual cost and twenty-five thousand rupees,
- Sale includes a transfer by way of exchange or a compulsory acquisition under any law for the time being in force but does not include a transfer, in a scheme of amalgamation.

Illustrations -11

If a machine costing Rs. 1 lakh is sold for Rs. 15,000. Depreciation of Rs 80,000 was written off on this machine., Terminal depreciation will be Rs 5000 (Rs. {1,00,000- Rs 80,000}- Rs. 15,000)

Illustrations -12

If the above machine is sold for Rs. 80,000, there will be surplus of Rs 70,000 (Rs. {100000- Rs 80000}- Rs. 90,000] . Surplus will be the balancing charge upto the extent of depreciation allowed.

Illustrations -13

Now assuming that the above machine is sold for Rs. 1,05,000. Then the surplus will be Rs 85,000 (Rs. {100000- Rs 80000}- Rs. 1,05,000}, of which Rs. 80,000 will be the balancing charge ; to the extent the total depreciation allowed and the remaining surplus amounting to Rs. 5000 will be treated as capital gain.

9. UNABSORBED DEPRECIATION

If there are no profits or gains chargeable for any previous year, the profits or gains chargeable are less than the depreciation allowance, as a result of which, depreciation cannot be fully deducted from the profits/gains, in that previous year, it is called unabsorbed depreciation.

Illustrations -14:

If the depreciation allowable is Rs. 50,000 and the income before depreciation is Rs. 30,000, the maximum depreciation can

be allowed up to Rs. 30000 and the balance of Rs. 20,000 will be unabsorbed depreciation

U/s 32(2) unabsorbed depreciation is allowed to be carried forward for indefinite period. The amount of the allowance for depreciation for the following previous year and deemed to be part of that allowance, or if there is no such allowance for that previous year, be deemed to be the allowance for that previous year, and so on for the succeeding previous years.

Since the unabsorbed depreciation is treated as part of the current depreciation, it can be set-off against any other head of income.

It is now well settled that in order to claim the set off of unabsorbed depreciation, business need not be continued. In other words, unabsorbed depreciation can be set off even if the business has been discontinued.

Illustration-15:

Suresh furnishes you with the following information regarding his income for the current previous asks you to determine his taxable income and unabsorbed depreciation

Particulars	Rs.
Business Income (before depreciation)	10,00,000
Depreciation allowable as per Income Tax Act	16,00,000
Income from other sources	8,00,000

Solution:

Particulars		Rs.
Business Income (before depreciation) Less: Depreciation to the extent of profits	10,00,000 10,00,000	NIL
Income from other sources Less: Unabsorbed Depreciation for the current year Rs. 16,00,000-10,00,000 already absorbed under business head	8,00,000 6,00,000	2,00,000
Taxable Income Rs.		2,00,000

Illustration-16:

What will be the position if the amount of depreciation is Rs. 20,00,000?

Solution:

Particulars		**Rs.**
Business Income (before depreciation) Less: Depreciation to the extent of profits	10,00,000 10,00,000	NIL
Income from other sources Less: Unabsorbed Depreciation for the current year Rs. 20,00,000- 10,00,000 already absorbed under business head limited to the extent of income available	8,00,000 8,00,000	NIL
Taxable Income	Rs.	NIL
Unabsorbed depreciation to be carried forward to next year	Rs.	2.00.000

Illustration-17:
Compute the written down value from the following information for the assessment year 2012-13

A. Written down value on April 1, 2011

Particulars	**Rate of Dep.**	**Rs.**
Plant A,B & C	15%	1,00,000
Plant D & E	40%	2,60,000
Plant F	50%	70,000
Building A & B	10%	2,00,000
Building C&D	5%	7,00,000
Building Temporary Sheds E&F	100%	2,00,000

B. Purchase during the previous year 2011 -12

Date	**Particulars**	**Rate of Dep.**	**Rs.**
02/02/2011	Plant G	50%	60,000
01/05/2011	Plant H	15%	18,000
01/06/2011	Furniture	10%	60,000
01/08/2011	Building G	5%	5,00,000
01/09/2011	Computer	60%	1,00,000
01/10/2011	Franchise Rights	25%	10,00,000

C. Sales during the previous year 2011 -12

DATE	PARTICULARS	(RS.)
31/10/2011	Plant C	25,000
31/01/-2011	Plant D	15,000
01/06/2011	Furniture	50,000
06/03/2011-	Building E	8,00,000

Temporary Sheds were put to use during the previous year.

Solution
Computation of Depreciation / Cost of Block

Block	Rate-%	Opg. Bal 1/4/2011	Purchases	Sales	Clg. Bal	Dep.	Net Block 31/03/12
Plant A/B/C	15%	1,00,000	18,000	25,000	93,000	13,950	79,050
Plant D/E	40%	2,60,000	-	15,000	2,45,000	98,000	1,47,000
Plant F/ G	50%	70,000	60,000		1,30,000	65,000	65,000
Building A& B,	10%	2,00,000			2,00,000	20,000	1,80,000
Building C/D /G	5%	7,00,000	5,00,000		12,00,000	60,000	11,40,000
Building E&F	100%	2,00,000		8,00,000	(6,00,000)	(6,00,000)	0
Furniture	10%	-	60,000	50,000	10,000	0	**0**
Computer	60%	-	1,00,000		1,00,000	60000	40,000
Franchise rights	25%	-	10,00,000		10,00,000	2,50,000	7,50,000

Note: Since block of temporary sheds ceases to exist, there will be no depreciation and Rs. 6,00,000 will be treated as short term capital loss.

Illustration-18:

Opening balance in a certain block of assets consisting of three cars (rate of depreciation: 20%) is Rs. 18,00,000. During the year 2011 -12 a new car is purchased for Rs. 6,00,000 and an old vintage car was sold for Rs. 24,00,000. Compute the Depreciation for the assessment year 2012-13

Solution

Computation of the value of Net Block

Particulars	Rs
Opening WDV of Block (Three Cars)	18,00,000
Add: cost of New Car purchased	6,00,000
Total (Four Cars)	24,00,000
Less: One Car Sold	24,00,000
Closing Balance Three Cars	0

WDV of the block is zero; no depreciation will be admissible for the A.Y. 2012-13 although three cars still exist in the block

Illustration-19:
In the above illustration, what would be the position, if all the four cars were sold for Rs. 2,00,000.

Solution

Computation of the value of Net Block

Particulars	Rs
Opening WDV of Block (Three Cars)	18,00,000
Add: cost of New Car purchased	6,00,000
Total (Four Cars)	24,00,000
Less: Four Car Sold	20,00,000
Closing Balance No Cars	4,00,000

As the block becomes empty on the last day of the previous year, no depreciation is admissible,. The residual WDV ion the block Rs. 4,00,000 will be treated as short term capital loss on sale of cars

10. SELF-EXAMINATION QUESTIONS :

1. Give a detailed note on depreciation
2. Is Depreciation always allowed on WDV ?
3. What happens when block ceases to exist?
4. Discuss the tax treatment when block comes to zero.
5. From the following data, calculate the depreciation admissible to an individual carrying on business, for A.Y 2012-13

Particulars	%	WDV
Factory Building	10	5,00,000
Plant & Machinery	20	8,00,000
Addition to Plant		1,00,000
Sale proceeds of Plant (cost 1,00,000)		5,00,000
Furniture & Fixture	10	1,00,000
Motor Car	20	60,000
New computer	60	60,000

(Ans; building Rs. 50,000, Plant & Machinery Rs. 60,000, Computer Rs.36000, Furniture Rs.10,000 & Motor Car Rs.12,000)

6.From the following figures, you are required to ascertain the depreciation admissible and other liabilities, if any. In respect of the previous year relevant to the AY 2012-13

Particulars	Plant & Machinery (Rs)	Building (Rs)
Rate of Depreciation	25%	10%
WDV at the beginning of the year	2,50,000	5,00,000
Additions during the year	3,00,000	Nil
Sales during the year	10,00,000	2,00,000

(Ans. P&M Rs. Nil Rs. 2,00,000 Short term capital gain, Building Rs. 5,000)

7. X Ltd. owns two plants on April 1, 2011 —Plant A and Plant B—(rate of depreciation: 15 per cent) with opening depreciated value of the block at Rs. 2,37,000.

X Ltd purchases Plant C also with depreciation rate of 15% on May 31, 2011 for Rs. 20,000 and sells Plant A on April 10, 2011 for Rs 10,000, Plant B on December 12, 2011 for Rs. 15,000 and Plant C on March 1, 2011 for Rs. 24,000,. Determine the WDV of the block as on 31/03/- and also the depreciation

{Ans. 237000+20000-49000 = 208000 Short Term Capital Loss, block empty, Depreciation –NIL})

8. Compute depreciation admissible to X for the assessment year 2012-13 on the basis of the following information:

Plant & Machinery A, B and C – Written Down Value as on April 1, 2011 Rs. 5,00,000 rate of depreciation 15%. Plant D purchased on June 12, 2011 rate of depreciation 15% for Rs. 40,000. Plant A sold on December 8, 2011 for Rs. 1, 60,000.

(Ans Value of Block 5,00,000 + 40,000 – 1,60,000 = 3,80,000 Dep. 57,000)

10

CAPITAL GAINS
(Sections 45 to 55)

Synopsis:

1. Introduction and Objectives
2. Basis of charge S.45/ 46A
3. Capital asset – S. 2(14)
4. Types of assets – Short Term & Long Term
5. Transfer –S.2(47)
6. Types of Capital Gains - S 2(29A/B)/(42A/B)
7. Period of holding
8. Computation of Capital Gains
9. Value of Consideration
10. Cost of Transfer
11. Cost of Acquisition
12. Fair Market Value
13. Transactions covered u/s 49(1)
14. Cost of improvement
15. Indexed cost of acquisition /improvement
16. Exemption on purchase of a new house –S. 54
17. Illustrations
18. Self Assessment Questions

1. INTRODUCTION AND OBJECTIVES

Capital assets represent the investments made from earning income –dividend, interest or rent chargeable to tax because income tax is a tax on income leaving the capital receipts outside its purview. Now the scenario has drastically changed and Capital gains arising on sale of capital assets are chargeable to income tax in the year in which the capital asset is transferred. Moreover, “transfer” “capital asset” have been assigned very wide meaning.

The lesson begins with the recognition of the fact that capital gain is a taxable income and deals with the tax treatment of the

capital gains including the concepts like meaning and types of capital asset, what is not capital asset, transfer, types of capital gains, concept of indexation and computation of the capital gains.

2. BASIS OF CHARGE:-SEC. 45/46A

Section 45 to 55A deal with the capital gains. U/s S 45 is the charging section,

It covers the following:

1. Capital gains arising on transfer of the capital assets and are taxable in the year in which transfer takes place. An analysis of the section shows bring outs the some conditions to attract tax liability. The conditions are:
   - There should be a capital asset ,
   - Assessee transfers the capital asset.
   - Transfer of capital assets takes place during the previous year.
   - There should be gain or loss on the transfer of the capital asset

Thus the capital gain will depend upon – existence of a capital asset, transfer of that capital asset during the previous year and resultant profit or loss from such transfer.

2. Receipt of money or other assets during in the previous year under an insurance from an insurer on account on account of **damage to or destruction of a capital asset**, as a result of:

   (i) Flood, typhoon, hurricane, cyclone, earthquake or other convulsions of nature or

   (ii) Riot or civil disturbance or

   (iii) Accidental fire or explosion or

   (iv) Action by an enemy or action taken in combating an enemy

3. Transfer by way of **conversion, by the owner of a capital asset into**, or its treatment by him as **stock-in-trade** of a business carried on by him, but is chargeable to tax in the previous year in which such stock-in-trade is sold or otherwise transferred by him.

4. Transfer made by depository or participant of beneficial interest in any securities during the previous year in which such transfer took place.

5. Transfer of a capital asset during the previous year by **a person to a firm** or other association of persons or body of individual (not being a company or a co-operative society) in which he is or becomes a partner or member by way of **capital contribution** or otherwise,
6. Transfer of a capital asset during the previous year by way of distribution of capital assets on **dissolution** of a firm or association of persons or body of individuals (not being a company or co-operative society) or otherwise
7. Transfer of capital asset by way of **compulsory acquisition** under any law but is chargeable to tax in the previous year in which such compensation; consideration or part thereof is received. Any additional compensation shall also be taxable in the previous year in which it is actually received. However, if the initial/ enhanced compensation is subsequently reduced by any court, tribunal or any authority, the capital gains assessed in the year of receipt of initial compensation or enhanced compensation will be amended to recomputed capital gains with reference to such reduced compensation.
8. Transfer of capital asset being the units of UTI or other mutual funds issued under the Equity-Linked Savings Scheme on the repurchase thereof by the mutual fund during the previous year.
9. Sale value of the shares issued to employees under an equity stock option scheme as reduced by the cost of acquisition / indexed cost of acquisition of the shares.
10. The value of a consideration received by share of a company under a scheme to buyback its own shares u/s 77A of the Companies Act, 1956 as reduced by the cost of acquisition /indexed cost of acquisition in the year of buyback. – **S 46A**

3. CAPITAL ASSET – S. 2(14);

Existence of a capital asset is the starting point attracting the capital gains tax. Capital asset is defined in S. 2[14] and means property of any kind held by the assessee including the property of his business or profession whether movable or immovable, tangible or intangible. However, S. 2[14] excludes the following;

a. **Raw material, stock, spares and other inventories** held for the purpose of the business or profession of the assessee.
b. **Personal effects** held for personal use of the assessee or of his family members dependent on him. Personal effects are movable articles and include items like domestic furniture, wearing apparels, and personal cars but do not include jewellery, ornaments made of gold, silver, platinum or other

precious metals and precious or semi-precious stones. In other words, though jewellery is a movable property held for personal use, it will still be treated as capital asset.

c. **Agricultural land** situated in rural areas i.e.

   a. areas not in the jurisdiction of a municipality or cantonment board having population of 10000 or more and

   b. within a radius of 8 kms from the local limits of such municipality or cantonment board called "urban area"

d. Special Bearer Bonds, 1991

e. 6 1/2 per cent Gold Bonds, 1977

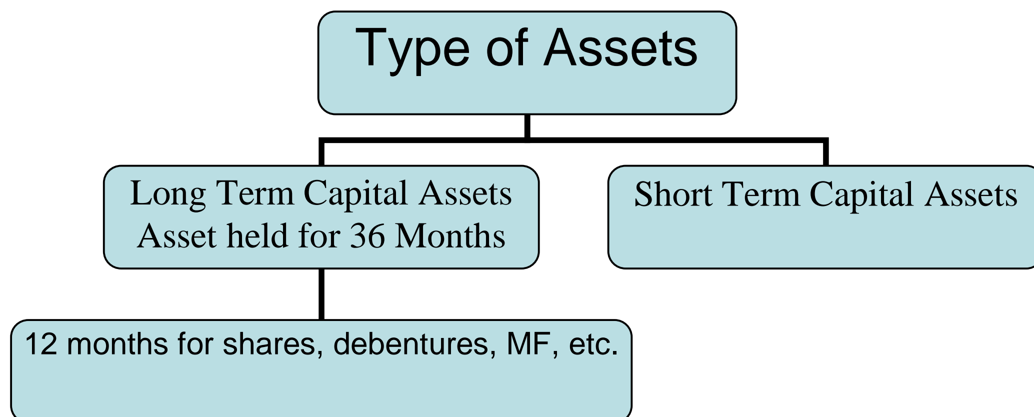
f. 7 per cent Gold Bonds, 1980

g. National Defence Gold Bonds 1980

h. Gold deposit Bonds issued under the Gold Deposit Scheme., 1999

4. TYPES OF ASSETS

Based on the period for which the asset is held by the assessee, Capital Assets can be classified into two types



i. Short Term Capital Asset **(STCA)**

Short-term capital asset means a capital asset held by an assessee for less than 36 months before it is transferred.

U/s 2(42A), the period of 36 months is taken as 12 months in the following cases:

a. Equity or Preference shares whether quoted or not,

b. Securities like debentures, government securities and notified derivatives, which are listed in recognised stock exchange u/s 10-23(D),

c. Units of UTI

d. Units of Mutual Funds

e. Zero Coupon Bonds

In other words, an asset, which is transferred within 36 months of its acquisition by assessee, is called Short Term Capital Asset. Transfer of STCA gives rise to Short Term Capital Gain STCG or capital loss – Section 2(29B).

ii. Long Term Capital Asses (LTCA).

An asset, which is not a short term capital asset i.e. held for more than 12/36 months before it is transferred is called long term capital asset. Transfer of LTCA gives rise to Long Term Capital Gain LTCG or loss – Section 2(42B).

5. TRANSFER –S.2(47)

Capital gain arises on transfer of capital asset. Therefore, not only there should be a “capital asset” but there should also be “transfer” of that asset. Both the conditions are cumulative and must be fulfilled together. The term “transfer” gains importance 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 gain.

For instance there will be no capital gain on transfer of personal motor car because motor car being a personal effect is not a capital asset. Similarly, A dies and his shares are transferred to his legal heir B. In this case though there is a capital asset, there is no transfer as devolution of asset unto heirs by succession shares of is not regarded as transfer. Hence there will not be any capital gain in this case also.

S. 2(47) defines “Transfer” It gives an inclusive definition:

“Transfer in relation to capital assets includes the following:

(1) the sale, exchange or relinquishment of the asset

Relinquishment of a right would mean the transfer of a right in favour of another person e.g. sale of right to subscribe shares.

(2) the extinguishment of rights on the capital asset,

Buyback of shares will be deemed to extinguishment of shares -s 46A.

Extinguishment of rights result in cessation or destruction or cancellation of rights in a capital asset like surrender of tenancy right

(3) the compulsory acquisition under any law,

(4) the conversion of capital asset into stock in trade of a business ,

(5) maturity or redemption of a zero coupon bond issued by an infrastructure capital company/fund or a public sector company on or after 1.6.2005 and notified by the central government in respect of which no payment or benefit is received before maturity/redemption,

(6) any transfer involving the allowing the possession of an immovable property u/s 53A of Transfer of Property Act, in part performance of the contract for transfer of that property.

(7) any transaction involving transfer of membership of a group, association housing society, company, etc, which have the effect of transferring or enabling enjoyment of any immovable property or any rights therein in any manner whatsoever.

(8) Distribution of assets on the dissolution of a firm, body of individuals or association of persons.

(9) Transfer of a capital asset by a partner or member to the firm or AOP, whether by way of capital contribution of otherwise

(10) Transfer under a gift or an irrevocable trust of shares, debentures or warrants allotted by a company directly or indirectly to its employees under the ESOP Scheme of the company as per the guidelines of the Central Government.

S. 47/47A exclude certain transactions from the definition. Some of them are with reorganization of business entitles like amalgamation, demerger, gift, will. These transactions are not in syllabus, hence not discussed.

6. TYPES OF CAPITAL GAINS

Based on the type of asset transferred by the assessee, Capital Gains can be classified into two types

i. Short Term Capital Gain **(STCG)**

Short-term capital gain is the gain arising on transfer of short term asset i.e. asset held by an assessee for less than 36/12 months is short term capital gain. Conversely any loss arising on the transfer of short term asset will be short term capital loss – Section 2(29B)

However, capital gains arising on sale of long term business assets in a block in case of a slump sale as covered under section 50 would treated as a short term capital gain or short term capital loss.

ii. Long Term Capital Asses **(LTCG).**

Long-term capital gain is the gain arising on transfer of a long term asset or an asset held by an assessee for 36/12 months or more. Conversely any loss arising on transfer of Long term asset will be Long term capital loss – Section 2(42B)

7. PERIOD OF HOLDING- S. 2(42A):

Type of capital gain is determined on the basis of the period of holding of the asset. In determining the period for which the capital asset has been held by the assessee the following are the important rules –

i. In case of shares held in company liquidation the period subsequent to the date of liquidation will not be included. Period of holding will stop running on date of liquidation..

Illustration-1;

A company goes into for winding up on 1st January, 2004. The liquidator settles the claim on 1st January, 2012. The period after 1st January, 2004 will not be taken as the period of holding.

ii. In case capital assets have become the property of the assessee in circumstances mentioned in S. 49(1) in determining the period, the period for which the capital asset was held by the previous owner will also be included.

Illustration- 2:

A dies 1st January, 2012 leaving a house purchased by him on 15th February, 2003. to his son B . B sells this house on 20th March, 2012. The gain arising from such sale will be long term capital gain as the holding will be calculated from the date of acquisition by the previous owner on 15th February, 2003.

iii. In case of shares in an Indian company which become the property of the assessee against shares of an amalgamated company, the period for which the **shares in the amalgamated company** were held by the assessee will also be included.

Illustration-3:

R Purchased shares of A Ltd on 12/11/2004. A Ltd is amalgamated with S Ltd. on 31/12/2011. Under the scheme of amalgamation, original 1000 shares in R Ltd were converted into 300 shares of S

Ltd. If A sells these 300 shares on 1/1/2012 it will be treated as long term capital gain as the period of holding will be reckoned from 12/11/2004 and not 31/12/2011.

iv. In case of **rights issue of shares** or other securities subscribed to by the assessee on the basis of his rights to subscribe, the counting of the period shall start from the date of allotment by such person or other person in whose favour such right has been renounced.

v. In case of **renunciation of a rights issue**, for the person who has acquired the rights, the period shall be reckoned from the date of the offer of such rights by the company or institution.

vi. In case of a **bonus issue**, allotted without payment on the basis of holding of any other financial asset, period shall be reckoned form the date of allotment of such financial asset.

vii. In case of shares in a resulting company received under a scheme of Demerger Company, the period for which the **shares in the demerged company** were held by the assessee will also be included.

viii. In case of shares of trading or clearing rights of a recognised stock exchange acquired by a person under its demutualisation or corporatization, the period for which, such person was a member will also be included.

ix. In case of equity shares allotted under demutualisation or corporatisation of a recognised stock exchange in India, the period for which such person was a member will also be included.

x. Period of holding of other capital assets will be decided according to the rules framed by the CBDT in that regard.

Important: The CBDT has clarified that date of transfer/ acquisition of shares will be considered on the basis of the brokers note / date of contract or date of allotment and FIFO (first in First Out Basis) in the case of Demat Accounts..

xi. In case of security or sweat equity shares allotted or transferred by the employer free of cost or at concessional rate to this employees including former employees, popularly called as ESOP, the period shall be reckoned from the date of their allotment or transfer.

8. COMPUTATION OF CAPITAL GAINS-SECTION 48

8.1. General Rule

Section 48 prescribes that the income under the head "Capital Gains" shall be computed. by deducting from the full value

of the consideration received or accruing as a result of the transfer of the capital asset the following amounts, namely :-

(i) Expenditure incurred wholly and exclusively in connection with such transfer;

(ii) The cost of acquisition of the asset and the cost of any improvement thereto:

8.2. Long Term Capital Gains

Where the capital gain is to be computed in respect of a long term asset, instead "cost of acquisition" and "cost of improvement", "indexed cost of acquisition" and "indexed cost of improvement" are to be deducted. However, there are two exceptions viz.-

a. In case of a non-resident, capital gains on transfer of shares or debentures of Indian company firstly by converting cost of acquisition, full value of consideration and expenses incurred for transfer into originally utilised foreign currency and reconverting capital gain into Indian rupees and

b. Benefit of indexation of cost will not be available on transfer of bonds and debentures even though they may qualify to be called long term capital assets., This is because bonds and debentures are normally issued and redeemed at par and if benefit of indexation is given, it will always give capital loss.

Mode of computation can be depicted as under:

<table>
<tr><td colspan="5">Short Term capital Gains</td></tr>
<tr><td colspan="5">Sales Consideration</td></tr>
<tr><td colspan="5">Less</td></tr>
<tr><td>Expenses on Transfer</td><td>+</td><td>Cost of Acquisition</td><td>+</td><td>Cost of Improvements</td></tr>
<tr><td colspan="5">Short Term capital Gains</td></tr>
<tr><td colspan="5">Long Term capital Gains</td></tr>
<tr><td colspan="5">Sales Consideration</td></tr>
<tr><td colspan="5">Less:</td></tr>
<tr><td>Expenses on transfer</td><td>+</td><td>Indexed cost of acquisition</td><td>+</td><td>Indexed Cost of Improvements</td></tr>
<tr><td colspan="5">Long Term capital Gains</td></tr>
</table>

Note: STCG computed above is further reduced by applicable deductions/exemptions such Sections 54B, 54D and 54G etc and LTCG is to be reduced by amounts exempt Sections 54, 54B, 54D, 54EC, 54ED, 54F and 54G, if applicable . As these provisions except S 54 are not in syllabus, the same are not discussed.

8.3. Depreciable Capital Assets– Sec. 50:

Where a capital asset has been sold or transferred and in respect of such capital asset depreciation had been allowed, the following rules will apply

A. Written down value of the block at the beginning of the year as increased by the cost of acquisition of any new asset falling in the same block purchased during the year and the incidental expense on transfer the asset sold. The balance will be the written down value of the block and there will be no capital gain.

B. If sales consideration exceeds the WDV of the block as increased by the new purchase and the incidental expense on transfer, such excess consideration will be treated as short term capital gain.

C. If the resulting figure goes in the negative, it will be treated as short term capital loss.

D. If block ceases to exist, that is all assets in a block are sold, the WDV in the block will be short term capital loss.

In other words capital gain will arise only if the full value of sale price exceeds the aggregate of the following:-

- Incidental expenses on transfer
- The written down value of the block at the beginning of the previous year.
- Cost of acquisition of the asset falling in that block of assets during the previous year

The resulting figure, if gain would be short term capital gain if loss would be short term capital loss. If block cease to exist, no further deduction will be available and no further deduction will be allowed.

<table>
<tr><th colspan="5">Depreciable capital Assets</th></tr>
<tr><td colspan="5" align="center">Sales Consideration</td></tr>
<tr><td colspan="5" align="center">Less</td></tr>
<tr><td>Expenses on transfer</td><td>+</td><td>Opening WDV</td><td>+</td><td>New Purchase</td></tr>
<tr><td colspan="5">• If surplus left in block to be considered for depreciation
• Any gain/loss will be short term capital gain / Loss
• If block ceases to exist no further deduction will be allowed</td></tr>
</table>

Illustration -4:

Opening written down vale of a block with 20% depreciation is Rs. 50,000

New asset purchased in the same block during the previous year Rs. 20,000

Calculate the depreciation/capital gain in the following circumstances:

1. If no asset was sold during the year.
2. If value of the consideration for asset sold is Rs. 70,000
3. If value of the consideration for asset sold is Rs. 40,000
4. If value of the consideration for asset sold is Rs. 1,00,000
5. If in case 3 both the assets are sold.

Solution:

Case (1): Value of block will be Rs 70,000 [Rs,50,000+20,000]and depreciation will be Rs.14,000 value of the block will be Rs. 70,000). Closing value of the block will be Rs. 56,000 . There will be no capital gain.

Case (2): Value of block is Zero i.e. (50,000+20,000-70,000). There are assets left in the block. Three will not be any depreciation nor any capital gain

Case (3) Value of block is Rs. 30,000 i.e. (50,000+20,000-40,000) and depreciation on this value will be Rs. 6, 000. Closing value of the block will be Rs 24,000 .There will be no capital gain.

Case (4): Block will cease to exist and there will be surplus of Rs. 30,000 (50,000+20,000-1,00,000). There will be no depreciation and Rs. 30,000 will be assessed as short term capital gain u/s 50.

Case (5)-Since both the assets are sold, there will be no block. Hence Depreciation will not be allowed. Rs. 30,000 will be the short term capital loss.

8.4. Depreciable Capital Assets of energy /power undertaking – Sec. 50A

Depreciable assets of an undertaking engaged in generation or distribution of power or energy, capital gain in respect of a depreciable asset will be computed with reference to the cost of acquisition as adjusted u/s 43(6) and the gain/loss will be computed accordingly as short term gain/loss.

Important: It is well settled principle that land is not depreciable asset. Therefore in a composite sale of land & building say a

factory is sold along with the land, depreciable asset will be building, Land will be considered as general capital asset. Building will be treated as a depreciable asset Profit or loss on the land may be long term if the land is held for more than 36 months.

8.5. Assets in Slump Sale – Sec. 50B

Slump sale means the transfer of one or more undertakings by way of sale for a lumpsum consideration without assigning values to individual assets and liabilities of the undertaking. In such cases of slump sale, the undertaking itself will be treated as a capital asset. Section 50B provides that profit arising from the slump sale of an undertaking/s effected in the previous year owned and held by the assessee for not less than 36 months is charged as long term capital gain and if it is held for less than 36 months, it is considered as short term capital gain. For the purposes of slump sale, 'net worth' [Sec. 50B (2)] of the undertakings shall be the cost of acquisition and improvement and no indexation u/s 48 is allowed in respect of such cost.

8.6. Sale of Land or building – Sec. 50C

Full Value of consideration for transfer of land or building or both – Sec. 50C – Higher of the following two amounts -

a. Full value of consideration received or accruing.

b. Value adopted or assessed by any authority of a State Government for the purpose of payment of stamp duty in respect of such transfer. Where the assessee claims that the consideration accruing or arising under the agreement is lower than the valuation adopted by the stamp duty/registration authorities, the assessing officer may refer it for valuation. However the consideration will not exceed the value adopted by the state authorities.

***Note**: Syllabus includes only S. 50. However these provisions of S 50/50A are overlapping with 32 – Depreciation, hence they are discussed in detail 50B/50C are for reference only*.

9. VALUE OF CONSIDERATION- S-48

Full total value of consideration means the value received or accruing as a result of the transfer. This is the amount for which a capital asset if transferred which may be in money or money's worth or both. Thus the sale price of an asset is the value of consideration accrued. Actual receipt is irrelevant. Hence capital gains are chargeable on accrual basis and not on cash basis.

Moreover, adequacy or otherwise is not the criterion except in cases where specific provisions have been made to ascertain the fair market value. Any consideration which cannot be expressed in

money's worth does not form part of full value of consideration for the transfer. The expression "full value of consideration" cannot be construed as having reference to the market value of the asset transferred or the adequacy of the price, but refers to the whole price bargained for between the parties.

One such case is transfer under a gift or irrevocable trust of shares, debentures, or warrants allotted by a company directly or indirectly to its employees under the Employees' Stock Option Plan or Scheme (ESOP) of the company in accordance with the guidelines issued by the Central Government, where the full value of consideration will be the fair market value of shares on the date of transfer.

Second case is the exchange of two or more assets. In such case the consideration of asset transferred will be equal to the fair market value of the asset received.

Another case is the loss of assets in natural conditions like tsunami, floods, earthquakes, any insurance claims received in respect of such destroyed assets would be deemed to be the full value of consideration.

Illustration 5:
A exchanges his flat for B's shop. In this case fair market value of A's flat will be the value of consideration for sale of B's shop and vice versa. Capital gain will arise on this transaction of exchange and the fair market value of the flat or shop will be the consideration.

Section 45, the charging section also lays down as to what should be considered as the consideration in some specific cases discussed above. These provisions can be tabulated as follows:

Sub sec.	**Transaction**	**Previous year when taxed**	**Value of consideration**
1	Sale or Transfer	Year of Sale or transfer	Sales consideration
1A	Damage or Destruction	Year of receipt of claim money	Money received or fair market value
2	Conversion into stock	Year in which stock is sold	Market value on the date of conversion
2A	Transfer of securities by depository	Year of transfer on FIFO basis	Consideration for transfer

3	Transfer as capital contribution in firm/AOP/BOI	Year of transfer	Value credited in capital account
4	Transfer on dissolution of firm/AOP/BOI	Year of transfer	Fair market vale on date of transfer
5	Compulsory acquisition	Year of receipt of compensation	Initial compensation or enhanced compensation as the case may be
6	Repurchase of mutual fund units	Year of receipt or discontinuation of scheme	Repurchase price

Illustration-6:
A purchased gold on 01/04/81 for Rs. 1,00,000. On 01/01/2004 he converted the personal gold into stock in trade. Fair market value on that day was Rs. 7,00,000. This gold was sold on 31/03/2012 for Rs. 12,00,000.

Solution:
On 01-01-2004 , capital gain will arise when gold is converted into stock. Capital gain will be Rs 2,37,000 i.e fair market value on 01-01-2004 – indexes cost of acquisition [7,00,000-{100000 X 463/100)]

This gain will be taxed in A.Y. 2012-2013 when the gold was actually sold. The difference between the sales price Rs 12,00,000 and the FMV on the date of conversion ito stock Rs 7,00,000 works out to Rs. 5,00,000, which will be taxed as business profit.

10. COST OF TRANSFER – SEC. 48(1)

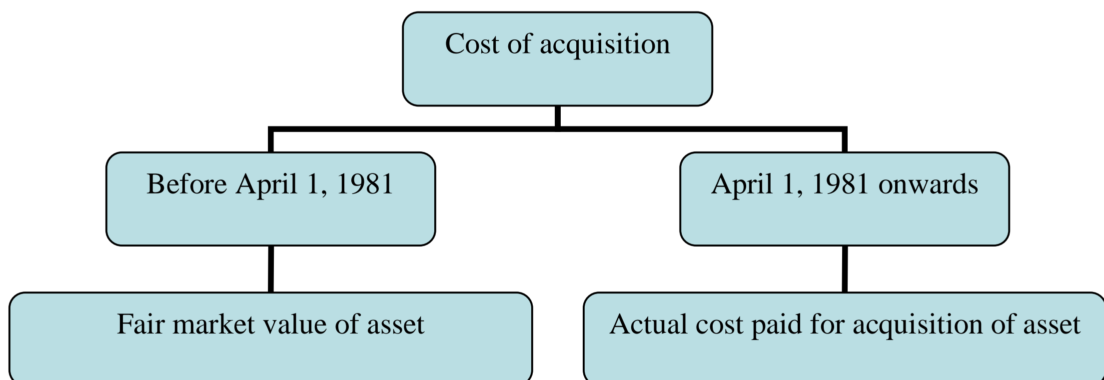
Expenditure incurred wholly and exclusively in connection with the transfer of asset is to be deducted from the total value of consideration while computing the capital gain. Some of the examples of such expenses are lawyers' fee for transfer, brokerage, travelling expenses for transfer, advertisement, stamp duty and registration fee if paid by the seller etc. This is subject to two conditions:

- Such expenditure must not be claimed as deduction as expenditure under any other head.

- The expenditure should be incurred wholly and exclusively in connection with the transfer.
- No expenses will be allowed in respect of share transactions covered under the securities transaction tax.
- Expenses like salary of an employee who helps in maintenance of capital assets will not be allowable since it is an expense not primarily for the transfer of the capital asset but helps in effecting the transfer by maintaining the capital assets.

11. COST OF ACQUISITION – SECTION 48 READ WITH SECTIONS 46 & 49

Cost of acquisition is the amount for which the capital asset was originally purchased by the assessee. It, therefore, is the sum total of amount spent for acquiring the asset. Where the asset is purchased, the cost of acquisition is the price paid and where the asset is purchased by way of exchange for another asset, the cost of acquisition is the value of the other asset on the date of such exchange. The relevant provisions may be summarised as under:



A. (1) Where the asset becomes the property of the assessee by a mode referred to in S 49(1) before 1.4.81:

i. Cost of acquisition is the actual cost to the previous owner or the fair market value as on **1.4.81** at the option of the assessee.

ii. Actual cost to the previous owner can not be ascertained Fair market value on the date on which the asset became the property of the assessee will be taken

iii. Where there are successive transfers under this mode, the reference to the previous owner will mean last of such previous owners who has acquired the assets by a mode otherwise than any of the modes u/s 49(1).

iv. In these case the period for which asset was held by the previous owner is also taken into consideration to determine the period for which the asset was held

A. (2) Where the asset becomes the property of the assessee by a mode referred to in S 49(1) on or after 1.4.81:

i. Cost of acquisition is the actual cost to the previous owner.

ii. Actual cost to the previous owner can not be ascertained fair market value on the date on which the asset became the property of the assessee will be taken.

iii. Where there are successive transfers under this mode, the reference to the previous owner will mean last of such previous owners who has acquired the assets by a mode otherwise than any of the modes u/s 49(1).

B. (1) where the asset becomes the property of the assessee by a mode other than referred to in S 49(1) before 1.4.81:

Cost of acquisition is the actual cost to the assessee or the fair market value as on **1.4.81** at the option of the assessee.

B. (2) Where the asset becomes the property of the assessee by a mode other than referred to in S 49(1) on 1.4.81 or thereafter:

Cost of acquisition is the amount actually spent by the assessee in acquiring the actual asset i.e. the actual cost of acquisition.

C. Where the asset becomes the property of the assessee subject to tax u/s 56 :

If any asset being cash, movable property, or shared of closely held companies with, or without consideration or immovable property without consideration has been subjected to in the manner prescribed in u/s 56, the cost of acquisition would be the cost taken u/s 56 for income tax purposes. The section is discussed in detail in the next chapter. The provision is apparently enacted to avoid double taxation of the same property.

D. Specific Cases:

i. Earnest money forfeited – S. 51;

Any earnest money received in advance and forfeited by the assessee, due to failure in negotiation is **reduced from the actual cost of acquisition or the fair market value as on 1.4.81** as the case may be and cost of acquisition will be adjusted accordingly.

Illustration-7:

A had acquired a building on May 12, 2000 for Rs. 28 lakhs. He wanted to sell the asset in 2004 and entered negotiation for this purpose. The prospective buyer gave him advance money of Rs. 5 lakhs at that time. However, the negotiations failed and A forfeited

the advance money. Subsequently, he actually sold the asset in August 2011 for Rs 45 Lakhs. Calculate the indexed cost of acquisition and the taxable capital gains on the sale of the building.

Solution:

Cost of acquisition for A will be Rs. 23 lakhs (Cost less money forfeited) i.e. Rs 28 lakhs less Rs 5 lakhs.

Indexed cost of acquisition::Rs 44,47,044 i.e 23,00,000 * 785/406

785 & 406 are the Index for financial years 2011– 12 & 2000– 01

Taxable Capital Gains: Rs [45,00,000–44,47,044[= Rs 52,956..

ii. Self- generated assets

In the wake of judicial decisions particularly the decision by the Supreme Court in B. C. Sreenivasa Shetty's case, assets generated in the course of business and profession without incurring any substantial capital expenditure, e.g. Patents, copyrights, goodwill, tenancy rights, etc. were normally regarded as not liable to capital gain tax as the cost of acquisition was Nil. To overrule this line of judicial thinking, the law has been amended to provide that in relation to the **Goodwill** of a Business, **Trade Mark** or **Brand Name** associated with a business, **Tenancy Rights**, **Loom Hours**, **Route Permits, Right to manufacture** or produce any process any article, cost of acquisition shall be taken as the **purchase price** if such price is paid, or **NIL**, if such price is not paid. Effectively, the entire sale proceeds less expenses on transfer of self- generated assets will be treated as capital gain. Where such assets have been acquired for a price from some other person, they cannot be called self-generated assets and therefore the other normal provisions of the Income Tax Act apply.

iii. Financial assets – shares and other securities:

Where an assessee becomes entitled to subscribe any additional securities, known as 'Rights" or where additional shares are issued as bonus i.e. without any payment, the cost of acquisition shall be as follows:

a. Amount actually paid for acquiring such asset by way of **subscription to the securities** or

b. Amount actually paid for acquiring such asset by way of exercising his **right or entitlement.**

c. **NIL** where rights are renounced**.** (In other words consideration for renouncement of rights will be the amount of capital gains as reduced by transfer cost, if any.

d. Amount **paid to the renouncer** of rights entitlement **and** amount paid to the **compan**y, which has allotted the rights shares

e. **NIL** in case of **bonus shares**- in other words, sales proceeds of bonus share will be liable to capital gain as reduced by transfer costs, if any. However if the bonus shares have been acquired prior to 1/4/81, then the share market value of bonus shares as on 1/4/81 will be treated as the cost of acquisition.

f. **Fair Market Value** on the date of **distribution o**f capital assets by a Company u/s 46 (2).

g. Cost of acquisition of the original asset Consolidation, division, conversion, reconversion of share into stock or vice versa and where such cost can not be reasonably ascertained, the fair market value.

h. **Cost of acquisition of the original shares** held by the **shareholders** in the **demerged company** as reduced by the amount arrived at u/s 49 (2C).

i. Cost of acquisition of original membership of a recognised stock exchange when equity share/s allotted to shareholders of **recognized stock exchange** under a scheme of demutualisation or corporatisation of the exchange – Sec. 55(2)(ab)

j. NIL in respect of trading or clearing rights of stock exchange.

k. *Pro rata* amount i.e. the amount which bears to the Cost of Acquisition of the shares held by the assessee in the demerged company the same proportion as the net book value of the assets transferred in a demerger bears to the net worth of the demerged company immediately before such demerger will be the cost of acquisition of Shares in the resulting company– Sec. 49 (2C).

l. Stock option Specified security taxed as perquisites u/s 17 (2) – Sec. 49 (2AA)

m. Actual cost of acquisition in all the other cases.

12. FAIR MARKET VALUE

Fair market value, in relation to a capital asset, means the price that the capital asset would ordinarily fetch on sale in the open market on the relevant date. If the assessee has acquired the asset prior to 1/4/81, he has the option of substituting the fair share market value of the asset as on 1/4/81 instead of actual cost of acquisition. However this option is available to the assessee only when the asset has been acquired prior to 1/4/81.Fair market value

is adopted in many cases like where ascertainment of actual cost is not possible; assets distributed on liquidation have already been dealt with at their appropriate places. Some other cases are considered below:

a) Conversion of capital asset into stock-in-trade

When the assessee converts a capital asset held by him into stock-in-trade, it will be treated as taxable transfer giving rise to notional capital gains or loss. For this purpose, the fair market value of the capital asset on the date of conversion is treated as notional sale proceeds from which the cost of acquisition / indexed cost of acquisition is deducted in order to get the capital gain. Later, when this converted capital asset is sold there will be business profit or loss i.e. actual sale proceeds less notional fair market value taken, as cost will be the taxable business profit or loss. However business income as well as capital gains will chargeable to tax only in the year of actual sale to a third party.

Illustration-8:

A jeweller converts his ancestral gold ornaments into the stock in-trade of his jewellery business on 1/1/2002. The ornaments are actually sold on 31/12/2011 for Rs. 15 Lakhs. The market value of these ornaments was Rs. 2 Lakhs on 1/4/81 and Rs. 12 Lakhs on 1/1/2002.

Solution:

This is a case of conversion of personal asset into stock in trade. The capital gain arises on the date of conversion i.e. 1/1/2002 but date of liability will be 31/12/2011 when the stock was in fact sold.

Being ancestral property, the fair market value of **Rs 5 lakhs** as on 1/4/81 will be the cost of acquisition.

On 01/01/2002(date of conversion), LTCG will be Rs. 3.48 Lakhs being the difference of market value on the date of conversion and the cost of acquisition. (Rs. 12 Lakhs - Rs. 2 Lakhs X 426/100)

On 31/12/2011, when the ornaments were actually sold for Rs. 15 lakhs , Rs. 3 Lakhs will be treated as business profit and Rs 3.48 lakhs as the LTCG for the A.Y. 2012 – 2013..

b) Introduction of capital asset by a partner:

When a partner transfers his personal asset by way of his capital contribution in a partnership firm, the amount credited to his capital account on account of this capital asset will be treated as sales proceeds in the hands of the partner from which the cost or indexed cost of acquisition will be reduced to get the amount of capital gains or loss taxable in the hands of the partner..

c) Takeover of assets by the partner on dissolution of the partnership firm

When a partner is allocated a capital asset upon the dissolution of a firm the fair market value of the capital asset on the date of dissolution of the firm will be treated as sales proceeds from which the cost of acquisition or indexed cost of acquisition, as the case may be, will be reduced to get the amount of taxable capital gains in the hands of the firm.

d) Compulsory acquisition of capital asset

Where there is compulsory acquisition of capital asset by the government or any government authority under law, there will be a taxable capital gain or loss in the year of such compulsory acquisition. However such capital gain will be chargeable only in the year in which the compensation is received. If the compensation is enhanced later, then the receiver of such additional amount is chargeable to capital gains in the previous year in which such additional compensation is received. If the compensation amount is subsequently reduced, the capital gain already charged will be recalculated as if it were a mistake apparent from the record u/s 155.

d) Amount received by shareholder on liquidation of the company:

Out of the money received by the shareholder, a part of the amount will be treated as deemed dividend under section 2(22) and the remaining amount less the indexed cost of acquisition or cost of acquisition, as the case may be, is taxable as capital gains on sale of the shares.

f) Capital Gains on Sale of Shares under Depository System

Where an assessee has any depository account and any shares are sold from the depository account, then such cost of acquisition of the shares sold will be determined on FIFO i.e. on first in first out basis. It will be assumed that the assessee is shares deposited in the account first were sold first and accordingly the cost of acquisition, date of acquisition and the period of holding will be calculated.

g) Stock Lending

Any share given under the stock-lending scheme approved by SEBI in this behalf will not give rise to any taxable capital gain.

h) Corporatisation of Stock Exchanges

In case any person transfers equity shares allotted to him as member of a recognised stock exchange in India under a SEBI approved scheme of corporatization of stock exchanges, his original cost of acquisition of membership of the stock exchange will be the cost of acquisition for computation of capital gains on those shares.

i) Demerger:
Cost of acquisition of shares in the resulting company in case of a demerger shall be determined as follows:-

$$\frac{\text{Cost of shares of the demerged company x Net book value of assets}}{\text{Net worth of demerged company before demerger}}$$

The cost of acquisition of the original shares in the demerged company shall be reduced by the amount calculated as above

j) Taxation of capital gains of listed shares:
Share are treated separately by the provisions of Sec. 111A/112, whereby an assessee is given the option to either pay a lump-sum tax of 15% and forego the benefit of indexation or alternatively pay regular tax under the normal provisions including indexation .

13. TRANSACTIONS COVERED U/S 49(1):

It has been stated earlier that the cost to the previous owner as well as the period for which the capital asset was held by the previous owner must be considered in cases of transfers covered u/s 49(1). This is because the capital asset *is not actually purchased* by the assessee in all these cases, nevertheless the assts becomes his property in any manner prescribed in S. 49(1) say gift or will. These items are as follows:

i. Acquisition of assets on the total or partial partition of a HUF.
ii. Acquisition of property under a gift or will not being gift or transfer through an irrevocable trust of shares, debentures or warrants allotted by a company directly or indirectly to its employees under a Central Government approved employees stock option scheme (ESOP). In such cases, the market value of the shares, debentures or warrants gifted or transferred to the irrevocable trust on the date of transfer will be treated as the sale proceeds for the purpose of capital gains.
iii. Acquisition of property by succession, inheritance or devolution.
iv. Acquisition of property on distribution of assets on liquidation of company.
v. Acquisition of property under a revocable or irrevocable trust.
vi. Acquisition of property on transfer by a wholly owned Indian subsidiary company from its holding company and by a parent company to its 100 per cent Indian subsidiary company.

vii. Acquisition of property on any transfer in scheme of amalgamation by the amalgamated company from the amalgamating company.

viii. Acquisition of property by Hindu undivided family where one of the members has converted its self acquired property into a joint family property.

Illustration-9:
An HUF acquired a flat on 30 June 1998 for Rs 5 Lakh. The flat was allotted to A as part of his share in HUF property on partition of the HUF on 31 May 2008 Compute the taxable capital gains if ,A sells the flat for Rs. 10 lakhs on 1 April 2011.

Solution:
0n 31-05-2008, when A was allotted the flat on partition of his HUF, **there is no taxable transfer in the hands of the HUF,** though there is a change in ownership of the flat from HUF to A on 01-04-2011.

For A, the date and cost of acquisition will be 30-06-1998 and Rs 5 lakh respectively being the actual cost and date of acquisition to HUF, though he became the owner on 31 May 2008. LTCG will be Rs 25,601– [Rs 7 lakhs – Rs 6,74,399] I.e 5 lakh* 785/582)

Note: Indexation is taken from 31-05-2008 on which ownership of flat transferred to A. Another view taken by Bombay & Delhi High Court says that indexation is to be taken from 30-06-1998. In that case there will be loss of Rs 4,18,234– [Rs 7 lakhs – Rs 11,18,234] I.e 5 lakh* 785/351

14. COST OF IMPROVEMENT:-S. 55(1)(B)

Cost of Improvement in relation to capital asset means any expenditure or cost of capital nature incurred by

i. the assessee or
ii. previous owner in case of an asset acquired by an assessee in any of the circumstances mentioned in S 49(1)

- for substantially improving or raising the value of the capital asset or
- in making addition or alteration to capital asset after date of acquisition or
- for any expenditure incurred to protect or complete the title of the capital asset or
- to cure the title of the property or remove any defect from the title.

In other words, cost of improvement includes all those expenditures, which are incurred to increase the value of the capital asset

Following additional points are noteworthy in this regard :

In case of a capital asset acquired prior to 1/4/81, where the fair market value of the capital asset as of 1/4/81 is substituted in place of cost of acquisition, all capital expenditure incurred by the assessee or the previous owner **after 1/4/81** in making any additions or alterations to capital asset will be included in cost of improvement but

a.) Cost of improvement incurred **prior to 1/4/81** will **be ignored** in all cases. 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 the fair market value is adopted and the fair market value of asset on 1st April 1981 will certainly include the improvement made in the asset.

b.) In any other case all the capital expenditure incurred in making in additions or alterations to the capital asset by the assessee after it become his property.

c.) There will be no cost of improvement to goodwill, right to manufacture or produce or process any articles or right to carry on any business.

d.) Any expenditure deductible from the income from house property will not be included in cost of improvement.

15. INDEXED COST OF ACQUISITION/ IMPROVEMENT – EXPLANATION (III) AND (IV) TO SEC. 48.

Under explanation (iii) to Sec. 48(iii) "Indexed cost of acquisition" means an amount which bears to the cost of acquisition the same proportion as Cost Inflation Index for the year in which the asset is transferred bears to the Cost Inflation Index for the first year in which the asset was held by the assessee or for the year beginning on the 1st day of April, 1981, whichever is later; Similarly under explanation (iii) and (iv) to Sec. 48(iv) "Indexed cost of any improvement" means an amount which bears to the cost of improvement the same proportion as Cost Inflation Index for the year in which the asset is transferred bears to the Cost Inflation Index for the year in which the improvement to the asset took place;

"Cost Inflation Index" **(CII)**for any year means such Index as the Central Government may, having regard to seventy-five per cent of average rise in the Consumer Price Index for urban non-manual employees for that year, by notification in the Official Gazette, specify in this behalf as given below:

In other words Indexed cost of acquisition/ improvement can be shown by the following formula:

Indexed cost of acquisition or improvement =

$$\frac{\text{(Cost of Acquisition/ Improvement)} \times \text{(Cost Inflation Index for the year of Transfer)}}{\text{Cost Inflation Index for the year of Acquisition/ Improvement / on 1.4.81)}}$$

Indexation benefit is not available in respect of the following:

a. Short term capital assets
b. Bonds and debentures
c. Where option of 15% tax rate is claimed/s 111A in respect of shares
d. Slump Sale U/s 50B
e. Sale of share, Foreign exchange assets by non residents u/s 115AB/AC/AD/D/ACA.

Cost inflation Index (CII) Notified

Financial Year	Index	Financial Year	Index
1981-82	100	1996-97	305
1982-83	109	1997-98	331
1983-84	116	1998-99	351
1984-85	125	1999-00	389
1985-86	133	2000-01	406
1986-87	140	2001-02	426
1987-88	150	2002-03	447
1988-89	161	2003-04	463
1989-90	172	2004-05	480
1990-91	182	2005-06	497
1991-92	199	2006-07	519
1992-93	223	2007-08	551
1993-94	244	2008-09	582
1994-95	259	2009-10	632
1995-96	281	2010-11	**711**
		2011 – 2012	**785**

16. EXEMPTION OF LTCG ON PURCHASE OF A NEW HOUSES-54

S 54 provides that any long-term capital gains arising on the transfer of a residential house (including self-occupied house) will be exempt from tax if,

1) If the assessee has within a period of one year **before** or two years **after the** date of such transfer **purchased,** or **within a period** of three **years constructed**, a residential house.

2) The assessee must not transfer the new house, within a period of **three years** from the date of its purchase or construction, as the case may be. Otherwise the exemption allowed under this section shall be reduced from the cost of the new house, in computing the capital gains arising therefrom.

3) If the whole or any part of the capital gain cannot be so utilised for acquisition a residential house before filling the return, the same should be deposited in Capital Gains Accounts Scheme, 1988 in order to claim exemption, before the due date for furnishing the return.

The amount of exemption available is **equal to the amount so utilised or the amount of capital gain, whichever is less.**

If the amount of capital gain is appropriated towards purchase of a plot and also towards construction of a residential house thereon, the aggregate cost should be considered for determining the quantum of deduction, provided that the acquisition of plot and also the construction thereon, are completed within the specified period as aforesaid.

To sum up, long term capital gain on sale of a house will be exempt to the extent it is invested in the purchase and/or construction of another house.

Certain points should be kept in mind:

1. The exemption is available only to individual and HUF assessees.
2. Exemption /s 54 is restricted to only long term capital gains arising on transfer of a residential house property.
3. Income of the Residential house income should be chargeable under the head 'Income from house property' either as self-occupied property or as let out property.

4. Capital gain arising on transfer of any other asset such as shares, Jewellery, office Car is not eligible for this deduction.
5. The exemption is available if assessee either purchases or constructs another house
6. The acquisition of the new property whether by way of purchase or construction must be within the following time limit

Purchase	One year before the transfer
	Two years after the transfer
Construction	Three years after the transfer

7. An assessee can **first sell** his house and **then purchase** a new house with in a period of two years or construct a new hose within a period of three years
8. Alternatively an assessee may **first purchase** a new house then within one year transfer the old house in respect of which the exemption is being claimed.
9. **But assessee can not construct new house before the old one is transferred. Construction cannot precede the transfer; it can only follow the transfer.**

Illustration 10:

A presently living in Bangalore in a flat purchased on 01/08/2009 for Rs. 25 lakhs,. He plans to shift to Ahmadabad. A seeks your advice when and for what amount should a new flat be purchased assuming that the present flat can be sold for Rs 60 lakhs. Can he sell the new house? .

Solution:

If the flat is sold any time before 01-08-2012, Rs 35 lakh will be taxed as STCG irrespective of the fact whether, when and for how much he buys the new flat as exemption u/s 54 will not be available on STCG. Further there will be no indexation.

This is because to claim exemption u/s 54 an asset must be a long term asset held for at least 36 months. Since the Bangalore flat is purchased on 01/08/2009, it would be long term capital asset after 31/07/2012. A should sell the flat only on or after 1/08/2012

Assuming that the flat will be sold on 01-08-2012 (the earliest date) , Capital gain will be Rs 28,94,778 : Rs 60 lakh –31,05,222 being (Rs 25 lakh *785/632) (index for F.Y. 2011-12 and 2009-10 respectively .

If investment in new flat is less than this amount, A will have to pay tax on the amount of gain short invested in new flat.

This sum of Rs 28,94,778 should be reinvested in acquisition of a new flat and the that must be purchased anytime on and after 31/07/2011 but on or before 31-07-2014 (one year before or two years after the transfer of Bangalore flat) alternatively he can construct a house before 31-07-2015 (Three years after the transfer).

New flat cannot be sold within three years after purchase or construction otherwise at the time of sale the benfit available u/s 54 will be reduced from the cost of acquisition and the capital gain will be STCG if the new flat sold before three years.

If A is under compulsion to shift to Ahmadabad, he can purchase a new house in Ahmadabad, any time on or after 1/08/2012 and plan the sale of Bangalore House accordingly, any time after 31/07/2012 so that he is not hit with one year before time limit. Alternatively, he can opt for a rental house and claim exemption in respect of rent paid u/s 10(13A) –from the House Rent Allowance.

If A does not purchase a new house and sells the Banglore house, he shall deposit this amount with a nationalized bank in capital gain deposit scheme on or before the due date of filing return. This mony can be withdrawn for utilisation for acquisition or construction of a new house.

17. ILLUSTRATIONS

Illustration 11.

State whether the following are the capital Asset or not:

1. Bicycle
2. Horse
3. Car
4. House for self residence
5. Jewellery
6. House let on hire
7. Silver utensils
8. Air Conditioner used as stock in trade
9. Air Conditioner not used as stock in trade
10. Rural Agricultural Land
11. Urban Agricultural Land

Solution:

Following are not capital assets

- **Personal effects**: items 1,2,3,7 and 8 i.e. Bicycle , horse cars , personal air conditioner and silver utensils if used for personal use , Item 9 Air Conditioner used as stock in trade
- Item 10 Rural agricultural land as it is excluded from the definition of capital asset.

Remaining items are all capital assets including , Item 4 House for self residence, item 5 Jewellery , item 6 House let out on hire , item 7 Silver utensils and item 11 Urban agricultural land as they are not excluded from the definition of capital asset .

Illustration-12

State whether the following transactions are transfer in relation to capital

1. A house transferred by way of will to son.
2. Bonus shares given by a company to its shareholders.
3. Giving away jewellery for a piece of land.
4. Getting money in lieu of shop in a shopping complex.
5. Giving the rights to use the asset.

Solution

1) Transfer by will is not transfer
2) Bonus share issue of capital not transfer
3) Both jewellery and land transferred
4) Shop transferred
5) Asset only hired not transferred.

Illustration -13 :

An asset was acquired on 31 May 1994 for Rs 10,000, it is substantially improved on 30 June 1996 for Rs 5,000 and it is sold on 10 December 2011 for Rs 75,000.

Solution:

Sales Consideration	Rs.	75,000
Indexed cost of acquisition 10000 X 785/259)	30,309	
Indexed cost of improvement (5,000 X 785/305).	12,869	43,178
Long Term Capital Gain		31,822

Illustration-14.

Suppose the asset in above example was acquired prior to 1/4/81 and improvement were also carried out prior to 1981. Assume there is no change in fair market value on 1/4/81.

Solution

Sales Consideration	Rs.	75,000
Indexed cost of acquisition 10000 X 785/100)	78,500	
Indexed cost of improvement (Prior to 1/4/81Ignored -S 55(1((b)	0	78,500
Long Term Capital Loss		3,500

Since FMV on01/04/1981 is optional, It would be advisable not to exercise the option as it would result in a Long Term Capital Loss.

3. Illustration-15:

A sells a residential house property in Mumbai for Rs. 30,00,000 on May 15, 2011. The house was purchased by him on June 11, 1982 for Rs 2,00,000. He purchases a new house for Rs 15,00,000 within six months Compute the capital gain

Solution:

	Rs.
Sales Consideration.	30,00,000
Indexed cost of acquisition 2,00,000X 785 /109	14,40,367 15,59,633
Deduction u/s 54 for new house	15,00,000
Long Term Capital Gain	59,633

Illustration-16:

A sells a flat on 13 March 1999 for Rs 5,00,000. He had acquired the flat on 15 August 1993 for Rs 1,00,000 and had incurred capital cost of major repairs of Rs 50,000 in 1994-95.

Solution

Sales Consideration	Rs.	5,00,000
Indexed cost of acquisition 1,00,000 X 351/244)	1,43,852	
Indexed cost of improvement 50,000 X 351 / 259)	67761	2,11,613
Long Term Capital Gain		**2.88,387**

Illustration-17:

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

The house property was sold for Rs. 7,10,000 on 1st April 2011. The expenses incurred on transfer of asset were Rs. 10,000.

a) Find the capital gain.
b) Will your answer be different if the house was constructed in March,2008

Solution:

a) if house constructed in 2000

Sales Consideration Less expenses 7,10,000-7-10,000)	Rs.	7,00,000
Indexed cost of acquisition 1,00,000 X 785/406	1,93,350	
Indexed cost of improvement 1, 10,000 x 785/447	1,93,177	3,86,257
Long Term Capital Gain		**3,13,473**

Holding of house is taken from the date of purchase of house . Construction of of additional floor is not relevant as it is the cost of improvement. .
b) If the house was constructed in March, 2008, it is held for 24 months only. Hence, since the house is held for less than 36 months, capital gain on sale of it will be Short Term Capital gain of Rs 4,90,000 as there will be no indexation.
[Rs. 700000- (1,00,000+ 1,10,000)= 4,90,000]

Illustration 18.
X acquired gold jewellery for Rs. 9,000 in 1970 (Market Value as on 1st April 1981 was Rs. 10,000). The jewellery was sold by X for Rs. 80000 in July, 2011. Calculate the taxable amount of capital gain, if the expense on transfer is 5%.

Solution:
x

Sales Consideration	Rs	80,000
Less: Indexed Cost of Acquisition10000x 785/100	78,500	
Expenditure on transfer (0.5% x 80,000)	400	78,900
Long Term Capital Gains		1,100

Illustration-19:

X invested Rs. 1,00,000 in ornaments and Rs. 50,000 in equity shares on 1st March 2009. He sold the jewellery for Rs. 1,20,000 and shares for Rs. 80,000 on 4th August 2011. 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:

Capital gain on sale Jewellery will be STCG as it is held for less than 36 months, and there will be no indexation.

Particulars	Rs.	Rs.
Sales Consideration		1,20,000
Less: Cost of Acquisition	1,00,000	
Brokerages on purchases (0.5% x100,000)	500	
Brokerages on Sales (0.5% x120,000)	600	1,01,100
Short Term Capital Gain		18,900

B. Capital Gain on Sale of Shares will be LTCG as the shares are held for more than 12 Months:

Particulars		Rs,	Rs,
Sales Consideration			80,000
Cost of purchase	50,000		
Add: Brokerage @ 0.5% on purchase	250		
Total cost	50,250		
Indexed cost of Acquisition 50,250 X 785 /480		82,180	
Expenditure on transfer (0.5% x80,000		400	82,580
Long Term Capital Loss			**2,580**

18. SELF ASSESSMENT QUESTIONS:

1. Write short note on:
   a. Short Term Capital Gain
   b. Cost of Acquisition
   c. Cost of improvement
   d. Expenditure on transfer
   e. Transfer

2. What is a capital asset for purpose of Income Tax Act, 1961? Discuss.
3. Write short notes on capital gains in the case of compulsory acquisition of a capital asset.
4. What types of transactions are included in the term “transfer” in relation to a capital asset?
5. State the situations under which the written down value of a “block of assets” will be reduced to nil.
6. Name any five items, which are not included in the definition of capital asset.
7. Discuss the provisions of the Income Tax Act, 1961 regarding:
   i. Conversion of capital assets to stock-in-trade.
   ii. Computation of capital gains in case of depreciable assets.
8. State whether the following are the capital Asset or not:
   a.) Bicycle
   b.) Horse
   c.) Car
   d.) House for self residence
   e.) Jewellery
   f.) House let on hire
   g.) Silver utensils
   h.) Air Conditioner used as stock in trade
   i.) Air Conditioner not used in own house
   j.) Rural Agricultural Land
   k.) Urban Agricultural Land
9. Whether the following transactions are transfer in relation to capital asset.
   a. A house transferred by way of will to son.
   b. Bonus shares given by a company to its shareholders.
   c. Giving away jewellery for a piece of land.
   d. Getting money in lieu of shop in a shopping complex.
   e. Giving the rights to use the asset.

   [Ans: only c and d are transfers]
10. Mungerilal who is a resident of Mumbai owns a house which was purchased at a cost of Rs. 50,000/- in the financial year 1983-84 was sold on 15 April 2011. The purchaser paid Rs. 4, 00,000/- on May 1, 2011 and the balance consideration of Rs. 2, 50,000/- was paid on June 30, 2011. Mungerilal paid brokerage of Rs. 13,000/- for the sale transaction. Compute the total taxable income of Mungerilal for the AY 2012-13

    (Ans: LTCG 48638i.e 4,00,000-13,000-338362 {50,000X 785/116)

11. Sharewala purchased shares in Indian companies (unlisted) as investment on 10th June 1982 for Rs. 2,00,000/-. On 1st June 2000 he started a business as a dealer in shares and transferred the entire holdings to the business. The market value of the shares as on that date was Rs. 8,00,000/-. The shares were sold by him for Rs. 9,20,000/- on 20th October 2011 Compute his income from capital gains from the above transactions for AY 2012-13

(Ans: LTCG Rs. 8.00.000- Rs. 2,00,000X406/109Rs.= Rs. 55,046/- for AY 2001-2002 & Business Profits Rs. 1,20,000/- taxable in AY 2012-13)

12. Aditya sold his only house property occupied by him as residential house for Rs 13 lakhs in the month of December 2011The house property was purchased by him in the month of February 1985 for a consideration of Rs 2 lakhs. Determine the capital gains.

(Ans: LTCG Rs 44,000, [13 ,00,000-12,56,000 Rs. 2,00,000X 785/125

13. Siddharth converts his plot of land purchased in July 1996 for Rs 60,000/- into stock-in-trade on 31st March 2004. The fair market value on 31.3.2004 is Rs 1,60,000/-. The stock-in-trade was sold for Rs 2,00,000/- in the month of January 2012. Find out the taxable income, if any, and if so under which "head" of income and for which "assessment year".

(Ans: LTCG 1,60,000-60,000 X 463/305 = Rs. 68,918/- in AY 2004-2005.& Business Income Rs. 40,000/- taxable in AY 2012-13)

14. X acquired a plot of land on 30.6.1992 for Rs. 2,20,000/-. Brokerage and other incidental expenses on acquisition of plot were Rs. 30,000/-. X sold the plot of land on 30.6.2011 for Rs. 10,00,000/-. What will be the amount of capital gain for AY 2012-13? Can he claim deduction for ground rent paid by him amounting to Rs. 5,000/- during the period when he held the asset?

(Ans: LTCG 10,00,0000-2,50,000X 785/223= Rs. 1,19,955 A. Y 2011-12, No)

15. A Purchases 250 equity shares of ABC Ltd on April 1, 1988 for Rs. 270/- per share and incurs expenditure of Rs. 500/- on brokerage and share transfer fees. On July 1, 1992 he gets 200 bonus shares. On September 1, 1994 he gets 300 right shares for Rs 140/- per share. On February 28, 2012 he sells all the 750 shares for Rs 400/- per share and incurs expenditure of Rs. 1,500/- on brokerage. Compute his taxable income for the AY 2012-13He does not have any other source of income.

(Ans: [750X 400]- 1500 –[[250X270+500] X 711/161]+0 +[300X140]X 711/259 = RS.1500. LTCG Rs. 4,082 in AY 2012-13)

16. Mrs. Padmini owned 2 motor cars which were mainly used for business purposes. The written down value on 1.4.2011 of the block of assets comprising of only these 2 cars, both of which were purchased in May 1999 was Rs. 1,81,000/-.These 2 cars were sold in June 2011 for Rs. 1,50,000/-. She had purchased the same during March 1999 for Rs. 2,44,000/-. ompute the amount of capital gain chargeable/ Depreciation.

    (Ans: Short Term Capital Loss on cars Rs. 31.000/- No depreciation as block empty)

17. P holds 500 shares of ABC Ltd which were allotted to him on 22.4.1996 at Rs. 30/- per share. On July 22, 2011. ABC Ltd made right issue to the existing shareholders at the rate of one share for every five shares held at Rs. 20/- per share. Mr. P instead of exercising his right to obtain right shares has exercised his right of renouncement by renouncing the said right entitlement in favour of Q at Rs. 13/- per right share entitlement on 4th August, 2011. Determine the nature and amount of capital gain, if any, taxable in the hands of P. What will be the cost of acquisition of shares purchased by Q?

    (Ans: STCG 1300 , Cost of Acquisition for Q Rs. 1,300/-)

18. Kishore Industries owned six machines which were in use in its business The written down value of these machines at the end of the previous year relevant to the assessment year 2011-12 was Rs. 6,50,000/-. Rate of depreciation is 25% per annum. A new plant was bought for Rs. 6,50,000/- on 30th November 2011Three of the old machines were sold on 10th June 2010 for Rs. 9,00,000/-. Compute :

    1. The claim to depreciation for AY 2012-13.
    2. Capital gains liable to tax for the same assessment year.
    3. If Kishore Industries had sold the three machines in June 2010 for Rs. 14,00,000/- will there be any difference in your above working? Explain.

    (**Ans: 1)-**100000 25% on Rs. 4,00,000 [Rs. 6,50,000+ Rs. 6,50,00- Rs. 9,00,000] 2)STCG Nil 3) Depreciation- Nil. STCG Rs. 1,00,000/-)

19. Arjun furnishes the following particulars and requests you to Compute capital gains chargeable to tax for the AY 2011-12:

    a) Jewellery purchased by him on 10.3.1995 for Rs. 1,05,000/- was sold by him for a consideration of Rs. 3,85,000/- on 2.11.2011.

b) He incurred expenses:

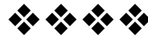
(i) At the time of the purchase Rs. 4,000/-

(ii) At the time of sale (for brokerage) Rs. 2.000/-

(Ans:LTCG RS. 52,633 {385000-2000 -[330367 ie [1,05,000+4000 X 785/259]

20. Sunder furnishes the following particulars for the previous year ending 31.3.2012 and requests you to compute the taxable capital gains.
He had a residential house inherited from his father in 1990, the fair market value of which as on 1.4.1981 is Rs. 5 lakhs. In the year 1992-1993, further construction and improvements costed Rs. 6 lakhs. On 10.5.200* the house was sold for Rs. 60 lakhs. Expenditure in connection with transfer Rs. 50,000/-

(Ans: LTCLOSS Rs 37,988 Rs. 60Lakhs - 54,68,004 [Rs. 5 lakhs X 785/100 + Rs. 6Lakh X 785/223]



11

INCOME FROM OTHER SOURCES
(Sections 56 t0 59)

Synopsis:

1. Introduction & Objectives
2. Basis of Charge
3. Incomes specifically chargeable u/s 56
4. Other incomes chargeable u/s 56
5. Some specific incomes – gifts, dividend
6. Deductions
7. Amounts not deductible
8. Miscellaneous- Balancing charge, Method of accounting
9. Self Assessment Questions

1. INTRODUCTION AND OBJECTIVES

"Income from other sources" is the last and most important head of income. It covers all such incomes, which are not chargeable under any other head of income viz salary, Income from house property, capital gains and profits and gains of business and profession. Thus "Income from other sources'' is the residuary head of income- S 56[1].

On the other hand, this head comprises of some well-defined incomes such as interest, dividend, winnings from lotteries and gifts, etc. some years ago, "Interest from securities" was a separate head of income now merged with the "Income from other sources"* S 56[2].

The lesson deals with this last and residual but most important head of income with computational aspects and also specific items that can be deducted from the income from other sources.

2. BASIS OF CHARGE- RESIDUARY -S 56(1)

Section 56(1) lays down that income of every kind which is not to be excluded from the total income and which is not chargeable under any of the specified heads shall be chargeable to income tax under the head “Income from Other Sources”.

In other words, income of every kind which are to be taxed, and which are not included in the income heads of salary, Income from house property, capital gains and profits and gains of business and profession shall be charged under the head Income from Other Sources.

3. INCOMES SPECIFICALLY CHARGEABLE S. 56(2)

Section 56(2) lists down incomes specifically chargeable to tax under the head “Income from Other Sources”. These incomes are:

i. Dividends u/s 2(22) (a) to (e)

ii. Any winnings from lotteries, crossword puzzles, races including horse races, card games and other games of any sort or from gambling or betting of any form or nature whatsoever.

iii. Any sum received by the assessee from his employee as contribution to any provident fund or superannuation fund or any fund set up under the provisions of the Employee State Insurance Act, 1948 or any other fund for the welfare of such employee is treated as income as referred under Section 2(24)(x), if not chargeable under the head business or profession..

iv. Income by way of interest on securities, if not chargeable under the head business or profession.

v. Rental income from machinery, plant or furniture belonging to the assessee and let on hire if not chargeable under the head business or profession.

vi. Where an assessee lets on hire machinery, plant or furniture belonging to him and also buildings and letting of the buildings is inseparable from the letting of the said machinery, plant or furniture, if not chargeable under the head business or profession.

vii. Any sum including bonus received under Keyman Insurance Policy shall be treated as income chargeable to tax under this head if not taxable as salary or business income.

viii. Aggregate of any sum of money exceeding Rs. 50,000 received without consideration by an individual or HUF on or after 1.10.2009

ix. Aggregate fair market value of movable property if it exceeds Rs 50,000 received without consideration by an individual or HUF after 1.10.2009

x. The difference between the aggregate fair market value and the consideration received if movable property exceeding Rs 50,000 is received for inadequate consideration received by any individual or HUF.

xi. The stamp duty value whether assessed or assessable of any immovable property if the stamp duty value of such property exceeds Rs 50,000 received without consideration by an individual or HUF after 1.10.2009

xii. Shares of closely held companies having aggregate fair market value exceeding Rs. 50,000 received by a firm or a closely held company without consideration on or after the 1st day of June, 2010 from any person or persons, the public are substantially interested, or for a consideration which is less than the aggregate fair market value of the property by an amount exceeding fifty thousand rupees, the aggregate fair market value of such property as exceeds such consideration :

xiii. income by way of interest received on compensation or on enhanced compensation referred to in clause (b) of section 145A.]

Some of these incomes are dealt with in detail in the paragraphs given below.

4. OTHER INCOMES CHARGEABLE UNDER THIS HEAD:

Income from other sources is the residual head of income comprising of all the incomes, which are not chargeable elsewhere. Therefore, apart from the incomes specified above, all the other incomes includible under any other heads of income the same will be charged under this head. Some of such items are as follows:

i. Dividend received from any entity other than domestic company. This is because dividend received from a domestic company is exempt under section 10(34) in the hands of the receiver. Accordingly dividend received from a cooperative bank or dividend received from a foreign company will be taxable as income from other sources.

ii. Any pension received by the legal heirs of an employee. Pension received by the employee himself during his lifetime will charged under section 17(3) as the income from salaries.

iii. Any winnings from lotteries, crosswords, puzzles, races including horse races, card games or other games of any sort or gambling or betting of any form or nature.

iv. Income from any plant, machinery or furniture let out on hire where it is not the business of the assessee to do so.

v. Income from securities by way of interest.

vi. Any sum received by the assessee from his employees as contribution to any staff welfare scheme. However when the assessee makes the payment of such contribution within the time limit under the scheme of welfare, then the payment will be allowed as a deduction; only the balance amount will be taxable.

vii. Income from sub-letting

viii. Interest on bank deposits and loans and securities.

ix. Royalty

x. Directors' fees

xi. Casual income

xii. Agricultural income when taxable e.g. land say situated in a foreign country,

xiii. Income from undisclosed sources.

xiv. Rent of plot of land

xv. Mining rent and royalty.

xvi. Casual income under a will, contract, trust deed.

xvii. Salary payable to a member of parliament.

xviii. Gratuity received by a director who is not an employee of a company.

xix. Any other receipt which is income but which does not fall under the other four heads of income viz. salary or business income or income from house property or capital gain.

5. SOME SPECIFIC INCOMES :

Some incomes are discussed because of their specific significance;

5.1. Dividend - Sec 56(2)(i)

Dividend means distribution of profits by the management to the real owners- the shareholders. Dividend may be in cash or kind

.it may be paid out of taxable profits or even tax free income or out of revenue profits or capital gains. In either case, Dividend is chargeable to tax.

Income from dividend from an Indian company is tax free in the hands of the shareholders as the distribution of dividends is taxable in the hands of the company.

Any deemed dividends u/s 2(22)(e) or dividend from any other entity is, however taxable in the hands of the recipient.

Normally dividend is taxable when declared at the Annual General Meeting of a company and not when received, but interim dividend is taxable on the basis of payment.

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

5.2. Deemed dividend: -Loan to shareholders- S. 2(22)(e)

According to section 2(22)(e), if a closely held company gives a loan or advance to a person for his individual benefit and the person is having substantial interest (10 per cent) in the company or to a concern(HUF/Firm etc) where the person having substantial interest has at least 20 per cent interest, then the receiver of that loan will be treated as if he has received the dividend amount to the extent of loan and it will be taxable in his hands as dividend income.

This provision has been inserted so as to prevent persons having substantial control and influence over the affairs of a company to take away all funds of the company as low-interest loans for their personal benefit to the prejudice of the other holders.

Some other important points should be kept in mind:

1. The dividend under this clause is taxed in the hands of the shareholder, who is entitled to set off the same if and when company declares any dividend. The dividend will be taxable in the year when the loan was given – S.8.
2. If the loan is repaid, dividend income will still be taxable in the hands of the recipient. The courts have repeatedly held that there is no inequity in this.
3. The loan will be taxable as dividend only to the extent of free reserves of the company.
4. The section will be applicable only on cash loans or advances and not on advances in kind say by way of sale of goods in the normal course of business.
5. Loans or advance made by the lending company for which lending is the main or substantial part of its business will also not be covered by this section ,

6. Any advance or loan made to a shareholder or the concern by a company in the ordinary course of its business, for purchase of its own shares or on demerger etc will also be not be covered under this section;
7. The dividend will also be subject to TDS
8. Substantial interest may be existing at **anytime** during the year

Illustration- 1

A , who is a shareholder having substantial interest in three companies A Ltd, B Ltd and C Ltd takes a loan of Rs. 20,00,000 from each of the three companies for purchasing a flat for himself. He however repays the same within a week as he is able to get housing loan from HDFC at concessional rates. Three companies have free reserves of Rs. 1,00,000, 1,00,00,000 and Rs. 0 respectively. Determine the taxability if dividend in the hands of A.

Solution:

- Out of loan taken from A Ltd. only Rs. 1,00,000 (to the extent of free reserve of the company) will be treated as deemed dividend u/s 2(22)(e) and not the whole of Rs. 20,00,000.
- For similar reasons, entire loan of Rs. 20,00,000 will be taxable as the dividend income in respect of loan taken from B Ltd.
- However, since C Ltd. has no free reserves; the loan taken will not be taxable in the hands of A as dividend.
- The fact that the loan has been repaid is immaterial. The only option A has is to claim set-off again the actual dividend as when declared by the companies. Even that would not be possible as the final dividend is tax free. Hence A will have no real benefit.

5.3. Deemed dividend – Distribution by Companies: S. 2(22)

Any distribution by the a company to its shareholders which entails the assets of the company or distribution made on liquidation or reduction of capital is regarded as dividend to the extent of accumulated profits of the company.

Similarly, any distribution by a company to its preference shareholders or debentureholders is also regarded as deemed dividend to the extent of accumulated profits of the company. Dividend in this class is directly taxable in the hands of the company.

5.4. Interest on securities.

Interest on securities is taxable as income from other sources unless it is taxed as business income. Normally, investments in government securities or under the other securities

like the debentures of company are considered. Many a times TDS is deducted from interest on such securities and the same should be added back and only the gross income should be considered. 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 taxable securities and non government securities.

From the Interest income from this head, reasonable bank charges and other collection charges, office and other expenses if the same were incurred for earning the income and interest payable on loans taken for acquiring securities can be deducted.

Illustration 2

A received Rs 18,000 as interest net of TDS @ 10% on debentures of B Tea Ltd worth Rs 2,50,000 held by him. Calculate the interest income and the amount of TDS @ 10% that can be claimed.

Solution

Since interest amount is net of TDS i.e 90% or [100-10%], it will have to be grossed up and the interest Income will be Rs.20,000 [i.e. Rs 17,940 / 90%]

TDS to be claimed Rs 20,000 - Rs 18,000 = Rs 2,000

Cross verify 10% of Rs.20,000 = Rs 2,000

5.5. Winning from Lotteries, Crossword puzzles, etc

Winnings from, Lottery, crossword puzzles, card games or other games including any game show like KBC and horse races, betting, gambling etc are all treated as income from other sources and taxed at the maximum marginal rate u/s 115BB. On the entire income without giving the benefit of:

- Claiming basic exemption limit
- Deductions under chapter VI-A.
- Expenditure including collection charges, etc or allowances;
- Benefit of set off and carry forward of losses.

Illustration 3

The winnings out of Sawaal Aapka were Rs 1,50,000. Calculate the net receipt.

Solution

Since such winning would be subject to maximum marginal rate is 30%, + 3% education cess and the secondary and higher education cess. TDS of 30.9% would be applicable.
TDS deducted = Rs 1, 50,000 X 30.9% = Rs 46,350
Net receipts of winnings = Rs 1, 50,000 – Rs 46,350 = Rs 1,03,650
Or Rs. 1,50,000X 69.1% = Rs 1,03,650

5.6. Family Pension

Family pension means a regular monthly payment made to the legal heirs of the employee after his death. This is treated as income from other source and not salary because there is no employer-employee relationship between the legal heirs and the employer.

Standard deduction equal to 1/3rd of the pension or Rs. 15,000 is available as deduction from this income. Significantly pension amount received during the life time of employee is taxable as salaries u/s 17(3) and not entitled to standard deduction.

Illustration 4

Mrs. S receives Rs 75,000 as yearly pension after the death of her husband. She pays Rs 2,000 per month to Ali to collect it from the office of the employer . Calculate the net taxable pension of Mrs. S**.**

Solution

Pension amount	Rs 75,000
Less: Lower of the following :	Rs 15,000
• 1/3 rd of the pension i.e. = Rs 75,000 X 1/3 = Rs 25,000 or	
• Rs 15,000	
Taxable Pension	Rs 60,000

The expenses occurred for collection of family pension to the extent of Rs 24,000 shall not be allowable as deduction since the standard deduction of 1/3 rd of family pension or Rs 15,000 is to cover such expenses.

5.7. Gifts

Finance Act, 2004 made a major deviation from the normal rule that gifts being capital receipts are not taxable and brought gifts received without consideration by an individual or HUF from any person on or after 01.09.2004 in the tax-net by amending S. 56. Since then, the section has been amended several times to widen scope of taxable gifts notably after 01/10/2009 and 01/06/2010. The legal position prevailing as of now is summarized as follows:

A. Taxable Gifts:

Following receipts by an individual or a Hindu undivided family, in any previous year from any person or persons will be taxable as " Income from Other Sources in the following manner:

a. Any sum of **money, without consideration**, **the aggregate value** of which **exceeds fifty thousand rupees**, the whole of the aggregate value of such sum

b. Any **immovable property, without consideration**, the stamp duty value of which **exceeds fifty thousand rupees**, the stamp duty value of such property;

c. Any property, **other than immovable property without consideration**, the **aggregate fair market value of which exceeds fifty thousand rupees**, the whole of the aggregate fair market value of such property or

d. Any property, **other than immovable property for a consideration which is less than the aggregate fair market value** of the property by an amount exceeding fifty thousand rupees, the aggregate fair market value of such property as exceeds such consideration

B. Exceptions:

The above clause does not apply to any sum of money or property received :

(a*) from any relative; or*

(b) on the occasion of the marriage of the individual; or

(c) under a will or by way of inheritance; or

(d) in contemplation of death of the payer or donor, as the case may be; or

(e) from any local authority defined in S 10[20]-Explanation

(f) from any fund or foundation or university or other educational institution or hospital or other medical institution or any trust or institution referred to in S. 10 (23C) ; or

(g) from any trust or institution registered under section 12AA

C. Certain Terms used :

i) Property: property" means the following capital asset of the assessee, namely:—

a. immovable property being land or building or both;
b. shares and securities;
c. jewellery;
d. archaeological collections;
e. drawings;
f. paintings;
g. sculptures;
h. any work of art; or
i. Bullion w.e.f 01/06/2010

ii) Relatives:

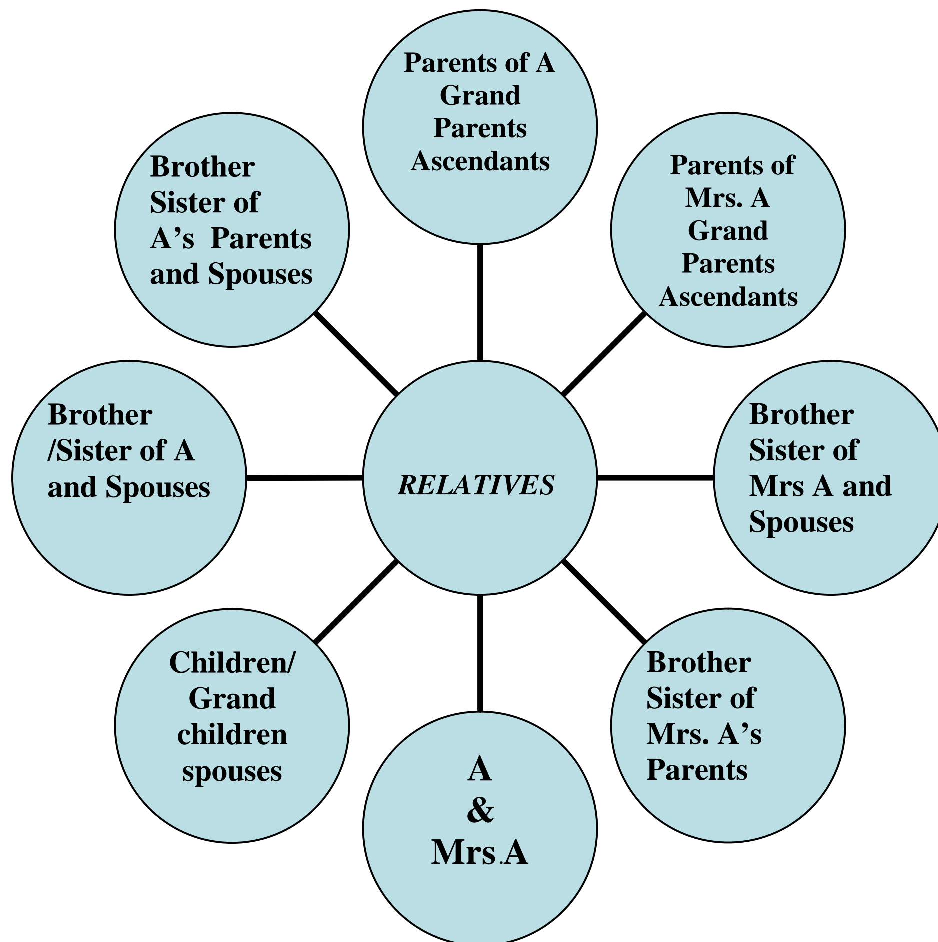
The Term "Relative "for this purpose means:

a. spouse of the individual;
b. brother or sister of the individual.
c. brother or sister of the spouse of the individual ;
d. brother or sister of the either of the parents of the individual,
e. any lineal ascendant or descendant of the individual

f. any lineal ascendant or descendant of the spouse of the individual
g. spouse of the persons referred to in (b) to (g) above.
h. In case of HUF, any member thereof

(*Introduced by Finance Act, 2012, retrospectively from 01-10-2009)*

This relationship is explained in a diagram



D. Cost of Acquisition :

When a property which has been taxed under these provisions, is transferred subsequently, its cost of acquisition will be the cost taken under this section. In other words if an asset has been under exempted category say a house received from a relative, the normal cost to the previous owner would be applicable. Similarly a painting has been valued at Rs 5,00,00 is transferred for Rs 3,00,000. Rs 2,00,000 will be charged u/s 56 being value of inadequate consideration. But while this painting is resold say for Rs 10,00,000 . The capital gain would be computed by taking the cost of acquisition of Rs 5,00,000

Note : However date of acquisition will be the date of acquisition by original owner, or the date of gift, in case of a property land as gift is not free from doubt and both the views can be taken, although the majority is in favour of taking date of gift as date of cost of acquisition.

TAXABLE GIFTS				
By Individual and HUF				**By Firms and Companies**
Aggregate Money received without consideration exceeding Rs 50,000	Aggregate Movable property received without consideration exceeding Rs 50,000	Aggregate Movable property received for inadequate consideration Difference between the fair market value and consideration exceeding Rs 50,000	Immovable property received without considerati on, if stamp duty value of such property exceeds Rs 50,000	Shares of closely held companies received without consideration or for inadequate consideration FMV/ Difference exceeds Rs. 50,000

Following are some important points to be kept in mind:

1. The limit of Rs 50,000 is for each category.
2. Rs 50,000 is not the basic limit. Once the limit of Rs 50,000 exceeds , entire sum will be taxable. For instance A receives cash gift of Rs 45,000 it will be exempt as it is below Rs 50,000 Now assume A receives another gift of Rs. 5,100 from C. The aggregate gifts of Rs 50,100 will be taxable without any basic exemption
3. However, in case of immovable property , the limit of Rs. 50,000 is per property as the section says " such property'
4. The list of relatives **does not include nephews/nieces/ cousins**
5. List of relatives includes Spouses, Siblings - own, spouses' and parents. lineal ascendants and descendants and spouses .
6. Stamp duty valuation will have same meaning as in S 50C.
7. Fair Market Value can be determined by the to valuers .
8. **Business assets like stock are not covered by this provisions and normal sale or purchase transactions will not attract the provisions of this section.**

9. Any movable property like shares, securities, jeweler, drawings, paintings, sculptures, work of art or archaeological collections, without consideration the fair market value of which exceeds Rs 50,000 in aggregate during a previous year, or for a consideration falling short of their aggregate fair market value by more than Rs 50,000 will be covered by this provision.
10. Inadequate consideration in respect of immovable property is not covered under this section.

Illustration 5:

Discuss the taxability of following gifts of 1000 shares of a company valued at Rs. 100 per share and Rs. 1,00,000 in cash received by Dr A from each of the following persons by:

1. B, his neighbour.
2. C, employer
3. D, one of his patients
4. E, his sister on the occasion of his daughter's marriage.
5. F, in contemplation of death.
6. Mrs. A
7. Mr. husband of E
8. H, son of E
9. X, a stranger on his marriage.

Solution

1) Gift from B (both cash and shares) will be fully taxable as income from other sources.
2) Gift from C (both cash and shares) will be fully taxed as income from salaries.
3) Gift from D (both cash and shares) will also be fully taxable as professional income.
4) Gifts from E (both cash and shares) will be fully exempt since it is on the occasion of marriage.
5) Gifts from F (both cash and shares) will be fully exempt since it is in contemplation of death.
6) Gifts from Mrs A (both cash and shares) will be fully exempt since she is the spouse of A.
7) Gift from E's husband (both cash and shares) will be fully exempt E is sister of A .
8) Gift from son of E (both cash and shares) will be taxable since nephew is not covered under the definition of relative.

9) Gift from X (both cash and shares) will be exempt since it is given on the occasion of marriage.

In sum A will be liable to pay tax on gifts of Rs 8,00,000 i.e. (1,00,000 X2) X4

A. Gifts Received by firms and companies [on or after the 1st day of June,2010] – S 56 (viia)

When a firm or a closely held company receives, in any previous year, from any person or persons, on or after the 1st day of June, 2010, any property, being shares of another closely held company having aggregate fair market value exceeding Rs 50,000 ,the whole of the aggregate fair market value of such property and if such shares are received for a consideration which is less than the aggregate fair market value of the property by an amount exceeding Rs 50,000 the amount of difference between the fair market value of such property and consideration :

Illustration :

A private Limited buys shares in B Private Limited of Rs 5 lakhs for Rs 1 lakh from form C , the difference in the consideration and the fair market value Rs 4 lakhs will be taxable under this section.

This section will not however apply to some transactions not regarded as transfer u/s 47 .

5.8. Income by way of interest received on compensation or on enhanced compensation referred to in clause (b) of section 145A.]

6. DEDUCTIONS -S. 57

Following deductions are available u/s 57 in computing the income from other sources:

I In case of taxable dividend income and interest from securities:

Any reasonable sum paid by way of remuneration or commission for the purpose of realising such income including interest on borrowed capital if such borrowed capital is used for making investment in shares or securities.

II In case of income from plant, machinery or furniture given out on hire:

a. Current repairs to building.

b. Current repairs to machinery, plant or furniture.

c. Insurance premium paid for insuring the plant, machinery, building or furniture.

d. Depreciation on building, machinery, plant or furniture.

e. Any expenditure (not being capital expenditure or personal expenditure) which has been incurred wholly, necessarily and exclusively for earning income, such expenditure will also be allowed as a deduction, e.g. sub-letting expenses. Office stationery, rent, salaries, etc where maintenance of office is necessary for earning the income.

III In case of family pension received by legal heirs of an employee,

A standard deduction of 1/3rd of such amount received as family pension or Rs. 15,000, whichever is less.

For this purpose, family pension means a regular monthly payment made to the legal heirs of the employee after his death. Significantly pension amount received during the life-time of employee is taxable as salaries and not entitled to standard deduction.

IV. Employees' contribution to Provident or any other fund if deposited before the due date.

V. Any allowances paid for breeding or maintaining the race horses.

VI. A deduction of 50% against the enhanced compensation received and no further deduction will be allowed from the income**.**

7. AMOUNTS NOT DEDUCTIBLE- S. 58

The following amounts are not deductible while computing income under the head "Income from Other Source":-

- Personal expenses of the assessee
- Any interest which is payable outside India on which income tax has not been paid or deducted at source.
- Any sum paid on account of wealth tax in India or abroad.
- Any amount not allowable by virtue of it being unreasonable
- In case of foreign companies, expenditure in respect of royalties and technical services received under an agreement made after 31/3/76.

- Any expenditure in connection with income from winning from lotteries, crosswords, puzzles, races including race horses, car races and other games of races, gambling, betting of any form. However expenses are allowed as a deduction in computing the income of an assessee who earns income from maintaining as well as holding race horses.

8. MISCELLANEOUS

I. Balancing charge taxable-S. 59

Under Section 59, any amount received or benefit derived in respect of any expenditure, incurred or loss or trading liability allowed shall be deemed to be the income of the year in which such benefits is accrued or received as the case may be.

II. Method of accounting.- S. 145

Section 145 relating to method of accounting is also applicable to the computation of income from other sources. Income under this head is computed in accordance with the method of accounting regularly employed by the assessee i.e. if the assessee accounts only on cash receipt and cash payment basis, income will be treated on cash payment and cash receipt basis only; otherwise it will be treated on mercantile basis. An assessee can adopt either the cash method or accrual method of accounting. Hybrid method is not permissible. However, certain items like lottery, horse races, dividend u/s 2(22)(e) can only be recorded on cash basis because of their variable nature.

III. Grossing Up:

Many times dividends, interest from securities are received after TDS. In such case amount to be included in total income is gross amount and not the amount received. Amount of TDS should be added back.

Illustration- 3.

A receives taxable interest of Rs. 13,500 after deduction of 10% TDS. Find out the taxable income.

Solution

Since TDS is 10% and gross amount is Rs. 100
Net amount will be Rs 90

Amounts to be taxed will be gross amount Rs 15000 i.e.

$$\frac{\text{Rs } 13500 \times 100}{90}$$

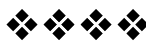
Rupees 15,000 will be included in the income and credit for TDS of Rs. 1,500 will be claimed against the tax payable.

9. SELF-EXAMINATION 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 included under the subhead of winning? What is the rate of tax on such incomes?
4) What are the deductions allowable in respect of hire charges of plant and machinery?
5) Are there any amounts, which are not allowed as deductions while computing the income from other sources? Give examples.
6) A is in receipt of pension as a retired government employee @ Rs. 10000 per month. Besides, he is in receipt of family pension of his late wife @ Rs. 6ooo per month. Show how the two amounts will be treated for tax purposes.,

   (Hint. Own pension salary / wife’s pension other sources with standard deduction Rs 15000)
7) Show the head of income under which the following items would be charged.
   a. Rent received by an event manager on letting out tents /pandal.
   b. Hiring charges received by a taxi driver.
   c. Car hiring charges received by a company from the cars requisitioned by the Election Commission
   d. Interest on Income Tax Refund
   e. Rent received by letting out own house and
   f. Rent received by sub-leasing premises.
   g. Computer hiring charges.
   h. Salary of director
   i. Salary of M.P/ MLA
   j. Rent of a house.
   k. Rent of a plot of land.
   l. Rent of a machine let on hire along with building and letting is separable.
   m. Dividend from domestic company.
   n. Winning from TV game show like.

   (Hints/Answers: item e/j remaining other sources. Director if employee, then salary)



12

DEDUCTIONS UNDER CHAPTER VI A

Synopsis:

1. Introduction and Objectives
2. Exemption Vs Deduction
3. Basic framework
4. 80C - payment for LIP etc
5. 80CCC – Contribution to certain pension funds
6. 80CCF – Subscription to Infrastructure Bonds
7. 80D – Medical insurance premia
8. 80DD – Deduction in respect of a handicapped dependent
9. 80E – Interest on Loan for Education
10. 80U – Deduction in case of a person with disability.
11. Typical solved illustrations
12. Self Assessment Questions.

1. INTRODUCTION AND OBJECTIVES:

Income Tax Act is not only a law to collect revenue for the government, but also a powerful tool in the hands of the Government to achieve many socio-economic objective and goals such as promotion of saving and investment, channelising of savings to certain desirable avenues like post office, mutual funds etc. encourage self–provision for social security through Mediclaim, LIC and other plans.

This is done by exempting incomes of all assessees or all incomes of certain assessees, or certain funds, institutes etc**.** Alternatively, direct relief in tax by way of rebates is offered to certain assesses or certain investments; or deductions in respect of certain income or in respect of certain payments or expenditure incurred by the assessee.

Rebates and exemptions have been dealt with in separate lessons. This lesson is concerned with the deductions contained in Chapter VI A of the Income Tax Act, 1961.

This lesson will deal with the basic framework of providing deductions while calculating total income of assesses in respect of certain receipts or payments specified in Chapter VI-A of the Income Tax, Act,1961. The lesson also explains the difference with tax incentives by way of exemptions, deductions or rebates and the deductions available from gross total income, conditions for claiming deduction and the amount of each deduction.

2. EXEMPTION VS DEDUCTION

Exemptions are allowed in respect of certain incomes or incomes of certain persons or incomes from certain sources. These incomes are not included in the computation of total income. Agricultural income in India for instance is exempt from tax altogether. All the incomes of charitable institutions are exempt u/s 11 to 13. Sections 10 to 13 deal with the exempt incomes or the incomes, which are altogether excluded from the taxable income of an assessee and conditions for such exemptions.

Deductions, on the other hand, may be both in respect of income or expenditure or receipts or payments. Deduction in respect of donation or mediclaim or donations or certain savings are the examples of payment or investment based deductions. Deductions in respect of export income [S.80HHC], Industrial undertakings [S80IA/IB etc] are the examples of deduction in respect of income. These incomes or expenditures are deducted after the Gross Total income is computed.

The lesson covers the following deductions namely:-

80C -- Deduction in respect of life insurance Premia, etc.
80CCC – Contribution to certain pension funds
80CCE -- Limits for deduction 80C/80CCC/80CCD
80CCF – Subscription to infrastructure Bonds
80D – Medical insurance premia
80DD – Deduction in respect of a handicapped dependent
80E – Interest on Loan for Education
80U – Deduction in case of a person with disability.

3. BASIC FRAMEWORK:

S. 80A, 80B and 80AB collectively lay down the framework of computation of total income.

S. 80 A provides that in computing the total income of the assessee, there will be certain **specific deductions** allowable from the gross total income under S. 80C to 80U to certain **specified tax payers**.

S. 80 B defines the Gross total Income as the total income computed under the provisions of this Act before making any deduction under this chapter.
Sec. 80AB mandates that the total deductions under this chapter shall not exceed the gross total income of the assessee. Further some of the deductions are available only to the extent of amount included in the gross total income.

There are some other important provisions in this connection such as :

a. Deduction can be **claimed only once**. Therefore, any deduction claimed and allowed while computing the total income of an AOP or BOI, will not be again deducted while computing the income of the member.

b. The aggregate amount of deductions under sections 80C to 80U cannot exceed gross total income

c. Deduction are allowable from the gross total income after excluding long term capital gains, short term capital gain under section 111A, winnings from lottery, crossword puzzles etc.

d. Therefore, no deductions under Chapter VI A are allowable on long term and short term capital gains u/s 111A or winnings from lottery which are taxed at a flat rate of 0% , 15% , 20% and 30% respectively.

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

4. DEDUCTION IN RESPECT OF LIC PROVIDENT FUND AND OTHER SAVING SCHEMES (S. 80C)

Section 80C provides for deduction in respect of investment or contribution towards specified saving schemes. The basic scheme of the section is as follows:

a. The deduction under S 80C is available only to individuals and Hindu Undivided Families. Other assessees are not entitled to the deduction under this section.

b. The deduction is allowable to resident as well as non-resident assessees.

c. The deduction is available if the amount is **paid or deposited** by the assessee in the previous year in the specified saving schemes.

d. The aggregate amount paid towards these schemes is called **Gross Qualifying Amount**.

e. The payments/investments eligible under this section are:

i. Life Insurance premium paid on a policy taken (or renewed) by an individual on his own life, life of the spouse or any child (child may be dependent/ independent) or any member of the family in the case of a Hindu undivided family. The premium including the arrears of premium should not exceed 20% of sum assured. .

ii. Any sum deducted from salary payable to a Government employee for the purpose of securing him or his wife or children to pay a deferred annuity subject to a maximum of 20% of salary

iii. Contribution towards statutory provident fund and recognized provident fund.

iv. Contribution towards 15 year public provident fund in the name of himself, wife or child or a family member upto a maximum of Rs 70,000.

v. Contribution towards an approved superannuation fund or a recognized provident fund.

vi. Subscription to National Savings Certificates, VIII Issue

vii. Contribution for participating in the Unit-Linked Insurance Plan (ULIP) of Unit Trust of India.

viii. Contribution for participating in the unit-linked insurance plan (ULIP) of LIC Mutual Fund (i.e. Dhanraksha plan of LIC Mutual Fund)

ix. Payment for notified annuity plan of LIC (i.e. Jeevan Dhara, Jeevan Akshay, New Jeevan Dhara, etc or any other insurer.

x. Subscription towards notified units of Mutual Fund or UTI

xi. Contribution to notified pension fund set up by Mutual Fund or UTI.

xii. Any sum paid including accrued interest as subscription to Home Loan Account Scheme of the National Housing Bank

xiii. Any sum paid as tuition fees (but not donation) to any university/college/educational Institution in India for full time education for maximum 2 children.

xiv. Investment in 10 / 15 years Post Office Cumulative Term Deposits CTDS

xv. Any subscription towards infrastructure bonds or units of Mutual Funds.

xvi. Any amount paid for the purchase or construction of a residential house property or for purchase of land

xvii. Term deposits for a fixed period for atleast 5 years with a scheduled bank under a notified scheme

xviii. Deposit in an account under Senior Citizens Savings Scheme, 2004

xix. Five year Post Office Time Deposit Account

xx. Subscription to notified bonds issued by NABARD

xxi. Subscription to equity shares or debentures of an Indian public company or subscription to any eligible issue of capital by an public financial institution where the entire proceeds of the issue is wholly and exclusively for the purposes of any business specified for developing, maintaining and operating an infrastructure facility for generation or generation and distribution of power or for providing telecommunication services whether basic or cellular or for developing, developing and operating or operating and maintaining an industrial park or a special economic zone- SEZ

f. Amount of deduction

Amount deductible u/s 80C will be the Gross qualifying amount i.e. aggregate of the amounts invested / spent in above mentioned schemes or Rs 1,00,000, whichever is less . Further, maximum deduction u/s 80C, 80CCC and 80CCD can not exceed Rs 1,00,000. In addition. a deduction of Rs. 20,000 will be available u/s 80CCF for subscription to infrastructure bonds over and above the deduction of Rs 1,00,000

g. Some important points:

- Payment for house may be made to authorised developers or even repayment of loans.
- The amount of investments need not necessarily be made out of the taxable income
- Life insurance premium paid for parents will not be allowable even if parents are dependent on the assessee.
- Life insurance premium paid for married daughter will be allowable.
- Dependence of wife or children is not necessary for claiming deduction under this section
- Refundable premium and bonus on premium are not eligible for deduction
- Premature termination(before the period shown below) from any scheme will have the following effects:

- In the year of termination deduction will not be allowed and

- Premium earlier paid and allowed as deduction will be brought back to tax in the current year and added to the total income in the assessment year pertaining to the year of withdrawal.

Premature withdrawal/Transfer/ Termination	
Life insurance Policy	Two years for whole life policy
	One year for other policy
P/O TDS / SCSS	Five Years
Unit Linked Insurance Plan	Five Years
House property-Transfer	Five Years

Illustration 1

A whole life policy on which a premium of Rs. 6,000 has been paid upto last year and Rs. 3,000 is the current year's premium otherwise eligible for deduction u/s 80C. What will be the effect if the contract is prematurely terminated during the financial year 2011-12?

Solution

Premium paid in financial year 2011-12 will not be eligible for deduction u/s 80C and the old premium of Rs. 6,000 allowed earlier will be added to the income of assessment year 2012-13.

Illustration 2

Calculate the deduction available under section 80C and the taxable income of Sam, having gross total income of Rs 6,60,000 and he makes the following expenses:

School fees of his 4 children	Rs 50,000
University fees of his wife	Rs 20,000
Life insurance for wife and kids	Rs 10,000
Life insurance for parents	Rs 15,000
Life insurance for father-in-law	Rs 10,000
NSC	Rs 20,000
Repayment of principal for house	Rs 35,000
Coaching class fees	Rs 11.030

Solution

COMPUTATION OF TOTAL INCOME

Gross Total Income		Rs. 6,60,000
School fees up to 2 children	Rs 25,000	
University fees of his wife - Not allowed	NIL	
Life insurance for wife and kids	Rs 10,000	
Life insurance for parent Not allowed	NIL	
Life insurance for father-in-law- Not allowed	NIL	
NSC	Rs 20,000	
Repayment of principal for house	Rs 35,000	
Coaching class fee Not allowed	NIL	
Deduction u/s 80C		Rs. 90,000
Total Income		Rs.5 ,70,000

Illustration 3

Aslam had a gross total income of Rs 5,00,000 for the AY 2012-13. He had availed of a deduction in AY 2010-11 of Rs 7,000 in respect of a Life insurance policy, which was prematurely terminated in P.Y. 2011-12. He made the following investments for the P.Y. 2011-12.

Insurance for himself (sum assured Rs 1,00,000)	Rs 28,000
Insurance for wife (employed with MNC)	Rs 25,000
Insurance for son but unpaid	Rs 7,500

Calculate the amount of deduction available to him under Section 80C and also the taxable income of Aslam.

Solution

Computation of total income		Rs
Gross Total Income		5,00,000
Add: Deduction of last year on termination of policy		7,000
Revised Gross Total Income		5,07,000
Insurance for himself (in excess of 20% of sum assured	Rs 8,000	
Insurance for wife (not a dependent	Rs. 25,000	
Insurance for son (not paid	Nil	
Total deduction u/s 80C		33,000
Total Income		4,74,000

5. CONTRIBUTION TO CERTAIN PENSION FUNDS- S. 80CCC:

S. 80CCC provides for a deduction in respect of contribution to certain pension funds. The scheme of this section is as follows:

i. Deduction is available to individuals only

ii. Deduction is in respect of amount paid or deposited in the previous year

  - To effect or keep in force any annuity plan of the LIC or other insurer approved by IRDAI
  - for receiving pension under such annuity plan from the pension fund referred to in section 10[23AAB]

iii. **Amount of deduction**

  Deduction shall be allowed to the extent of lower of the following - in the previous year

  - amount so paid or deposited excluding interest/ bonus accrued or credited or
  - Rs. 1,00,000
  - Subject to overall cumulative limit of deduction u/s 80C, 80CCC and 80CCD Rs 1,00,000-[section 80CCE]

iv. If the assessee or his nominee surrenders the annuity before its maturity, the surrender value including bonus/ interest shall be taxable in the year of the receipt.

v. The pension amount received by the assessee or his nominee from this fund is taxable in the hands of the assessee or his nominee in the year of his receipt.

vi. Amount qualifying for deduction under this section will not be eligible for deduction under Section 80C and education under this section will be allowed if the payment of contribution has not been claimed as deduction under section 80C.

6. DEDUCTION IN RESPECT OF SUBSCRIPTION TO LONG-TERM INFRASTRUCTURE BONDS - S. 80CCF:

S. 80CCF provides for deduction in respect of subscription to long-term infrastructure bonds.

- The deduction is available only to an individual or a Hindu undivided family .

- The deduction is in respect of subscription to long-term infrastructure bonds notified by the Central Government
- Amount of Deduction : the whole of the
  - amount subscribed or
  - Rs. 20,000

  whichever is less .
- *The deduction is over and above the Rs 1,00,000 in other saving schemes . In strict terms, the deduction may not be in the syllabus, but is briefly mentioned here to make the topic meaningful and comprehensive.*

7. MEDICAL INSURANCE PREMIA- S. 80D:

S. 80D provides for a deduction in respect of the payment made by an individual or a HUF towards medical insurance premia subject to following conditions:

i. The deduction is available only to **an individual or HUF, whether resident or non-resident.**

ii. In the case of non-resident, the deduction would be allowed subject to the fact the non-resident was entitled to hold such insurance policy.

iii. The deduction is in respect of :

- premium paid under a Medical Insurance Scheme of the General Insurance Corporation approved by the Central Government or any other insurer approved by the Insurance Regulatory and Development Authority popularly known as Mediclaim Policy.
- contribution paid towards the Central Government Health Scheme with effect from A.Y. 2012-13,

iv. Such premium is paid by mode other than cash such as cheque, credit card or electronic clearance ECS, internet banking etc

v. **Amount of Deduction-** HUF :

The deduction for a HUF shall be to the extent of lower of the following

- premium paid on the insurance for the health of any member or
- Rs. 15000 Or
- Rs. 20,000 , If any insured member of the family is a senior citizen .

vi. Amount of Deduction- individual assessee;

In case of an individual assessee, the amount of deduction shall be aggregate of the following :

A. premium paid on the insurance for self, spouse and dependent children or

- Rs. 15000 OR
- Rs. 20,000 in case any insured person is a senior citizen AND

B. **Amount of Additional Deduction for parents -** individual assessee

Premium paid for insurance of health of any parent or parents or

- Rs. 15000 OR
- Rs. 20,000 in case any insured person is a senior citizen

vii. Senior citizen means **an individual resident** of India who is of the age of 65 years or more at any time during the relevant previous year. Therefore , if the senior citizen is a Non resident **, deduction will of Rs 15,000 not Rs 20,000,**

viii. The parents and the spouse need not be dependent upon individual assessee but children should be dependent for claiming the deduction

Illustration4

Boman paid mediclaim insurance for his wife who is working in Coffee House Inc of Rs 10,000. He also pays Rs 12,000 for each of his parents who are senior citizens and Rs 5,000 for his children who are working in PSUs. He pays Rs 8,000 for his own mediclaim. Calculate the amount of deduction allowable u/s 80D.

Solution

Amount of deduction u/s 80D		
Premium in respect of wife	Rs 10,000	
Premium for himself	Rs. 8,000	
Premium in respect of children (not dependent)	Nil	
Total but restricted to	Rs. 18,000	Rs 15,000
Premium in respect of parents (senior citizens)	Rs 24,000	Rs 20,000
Deduction available u/s 80D		Rs 35.000

8. EDUCTION IN RESPECT OF MAINTENANCE OF A HANDICAPPED DEPENDENT – S. 80DD

S. 80 DD, provides for deduction in respect of maintenance and treatment of a handicapped dependent. The provisions of the section are explained below:

i. Eligible assessee:

Only an individual or a HUF assessee resident in India is eligible to claim deduction under this section.

i. Eligible Payments:

Deduction is available in respect of the following:

a. Expenditure incurred for medical treatment including nursing, training and rehabilitation of a dependent, being a person with disability or

b. any amount paid or deposited under a scheme framed by LIC or UTI or other insurer approved by the CBDT for maintenance of a dependent being a person with disability

ii. Amount of Deduction :

Rs. 50,000 [Rs 1,00,000 if the dependant suffers from severe disability].

It is necessary to spend some eligible amount and the amount spent need not be the full amount claimed. Full deduction of Rs. 50,000/1,00,000 will be allowed if SOME amount is spent.

iii. Conditions: for of Deduction :

The deduction can be claimed subject to the following conditions:

a) Deduction is available in respect of a dependent. A dependent in relation to an individual means self, his/her spouse, children, parents or brothers and sisters and in relation to a HUF means any of its members , who is wholly or mainly dependent upon the Assessee ;

b) Such dependent person should not claim deduction U/s 80U while computing his total income ;

c) The assessee nominates either the handicapped dependent or any other person or trust to receive the payment under the scheme for the benefit of the handicapped dependent ;.

d) In the event of the death of the subscriber assessee, the amount of annuity or lump-sum under the scheme is paid for the benefit of the handicapped dependent.

e) If the handicapped dependent predeceases the subscriber assessee, then the amount so received shall form part of the

total income of the subscriber assessee in the previous year in which the amount is received.

f) The assessee must furnish a certificate from a neurologist (in case of children, a paedriatic neurologist) or a civil surgeon or Chief Medical Officer of a Government hospital in form 10IA (in case of autism, cerebral palsy or multiple disability)

g) Where the condition of disability requires reassessment, a fresh certificate shall have to be obtained on expiry of the period mentioned in the original certificate.

9. DEDUCTION IN RESPECT OF INTEREST ON LOAN FOR EDUCATION - 80E

S. 80E provided for deduction in respect of Interest on loan taken for higher studies. Provisions of the section are explained below:

a. Eligibility:

Any individual assessee, whether resident or non-resident, who has taken a loan from any financial institution or any approved charitable institution for the purpose of pursuing his higher education of for the purpose of his relative's higher education.

'' Higher education'' means any course or study pursued after passing Senior Secondary Education or its equivalent from any Government recognized school, Board or university.

b. Amount of deduction ;

Any amount paid by the assessee in respect of interest on such loan without any limit paid out of his taxable income during the previous year will be eligible for deduction under this section.

c. Other important points :and conditions:

i. Higher education may be for the assessee or any of his relatives. Relative means the spouse and children of the assessee or the student for whom such individual is the guardian.

ii. Deduction is available in respect of any post-SSC course whether full -time or part time any Government recognised school, Board or university.

iii. The deduction can be claimed for a maximum period of 8 years starting from the year in which the payment of interest on the loan begins or till the interest is paid in full, whichever is earlier.

iv. The deduction can be claimed by the student assessee himself if the interest is paid by him.

v. Where the interest is paid by a relative, such relative can claim the deduction in respect of the interest paid for the student's loan.

10. DEDUCTION IN CASE OF A PERSON WITH DISABILITY - 80U

S. 80U contains a welfare measure to help a disabled person by reducing his tax burden by providing a deduction. The deduction is available if the following conditions are satisfied:

i. The Assessee is an individual resident of India.

ii. He is a person with disability at anytime during the previous year.

iii. Prescribed medical authority must certify him to be a person with disability in the prescribed form and the certificate should be submitted along the return of income of the assessment year for which the deduction is claimed for the first time.

iv. Where the condition of disability requires reassessment of its extent after a period stipulated in the medical certificate, deduction for any year falling after the expiry of such period shall be allowed only if a new certificate is obtained and furnished.

v. Amount of deduction will be a flat amount of :

   -Rs. 50,000 in case of a person with disability (minimum disability of 40%) and

   -Rs. 1,00,000 in case of a person with severe disability i.e. any disability over 80%)

vi. There are no conditions for amount being spent to avail the deduction. Mere submission of a disability certificate will be enough to avail the deduction. Terms used (For reference only)"Disability" means blindness, low vision, leprosy-cured, hearing impairment, locomotor disability, mental retardation, mental illness, autism, cerebral palsy and multiple disabilities.

   "Person with disability" means a person so referred under the Persons with Disabilities (Equal Opportunities, Protection of Rights and Full Participation) Act, 1995 or the National Trust for Welfare of Persons with Autism, Cerebral Palsy, Mental Retardation and Multiple Disabilities Act, 1995.

"Person with severe disability" means a person with 80% or more of one or more disabilities as referred to in Section 56(4) of the 1995 Act or a person with severe disability referred to in Section 2(o) of the 1999 Act referred to above.

11. TYPICAL SOLVED ILLUSTRATION

Illustration 5

S presents his financial data as follows the previous year 2011-12

1. Business income Rs.8,10,000
2. Capital Gains Rs. 3,15,000
3. Payment of medical insurance premium on own life Rs.5,000
4. He pays Rs. 20,000 to GIC for maintenance of his severely disabled son under an approved scheme.
5. He has borrowed Rs 5,00,000 as educational loan for his younger son who pursues MBA from IIM and pays 10% interest on the loan.
6. S himself his severely disabled.

Determine the income of S for the assessment year 2012-13

Solution:

Computation of Total Income of X

		Rs
Business Income		8,10,000
Capital gains		3,15,000
Gross Total Income		11,25,000
Deductions under chapter -VIA-		
80D :Mediclaim	5,000	
80DD:Maintenance of dependent with severe disability	*1,00,000	
80E interest on study loan	50,000	
80U :Severe disability	1,00,000	
Total Deductions under chapter -VIA-		2,55,000
Total Income		8,70,000

Note : Full Rs. 1,00,000 available . Amount of expenditure not relevant

12. . SELF EXAMINATION QUESTIONS:

1) Distinguish exemption and deduction with the help of illustrations..

2) Define Gross Total Income.

3) Write the provisions of Section 80C under the Income Tax Act, 1961.

4) What is the amount of maximum deductions under Section 80D?

5) Briefly explain the provisions available under the Income Tax Act relating to deductions from the Gross Total Income in the case of blind or physically handicapped person.

6) The net profit as per the Profit & Loss Account was Rs. 2, 85,000 after taking credit of Rs. 45,000 received on maturity of LIC policy and Rs. 30,000 as Interest from government securities and donation of Rs. 40,000 to BMC for promotion of family planning and Rs 5,000 as alms to destitute. He also pays Mediclaim for self Rs 20.000 (Rs 10,000 in cash and Rs. 10.000 via credit card and Rs. Rs. 25,000 for his 70 year old father

   Compute on the basis of the above information total income for the A.Y. 2012-13

(Ans: Bus. Income 2,47,000, other sources 30,000 GTI 2,77,000, Total income 2,47,000)

7) A person, who is physically handicapped (75%)and is a resident of India, earns a net income of Rs 5, 76,000 from a consultancy business run by him. You are required to compute his total income for the AY 2012-13

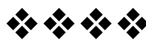
(Business income 576,000, deductions, 80U- 75,000 total Income 5,01,000)

8) The gross total income of Sam is Rs. 2,00,000. The total deductions Chapter VI-A except 80G is Rs. 20,000. He has paid the following sums to certain funds and charitable institutions:

(i) Indira Gandhi Memorial Trust Rs. 5,000

(ii) Delhi Municipal Corporation to be utilized for promoting family planning Rs. 20,000

Compute deduction u/s 80G regarding donations.(Ans. Rs. 20,500)



13

COMPUTATION OF TOTAL INCOME

Synopsis

1. Introduction and Objective
2. Calculation of Net taxable Income
3. Performa Statement of taxable income
4. Typical Illustrations
5. Self Assessment Questions.

1. INTRODUCTION AND OBJECTIVES

Once the income is calculated under the individual heads of income viz. salaries, house property, business income, capital gains and other sources, the final stage involves the computation of income and ascertains the tax thereon. Aggregate of income under these heads is called Gross Total Income, From the Gross Total Income so calculated, amounts deductible under Chapter VI-A are reduced. The net result is **Total Income** or **Taxable Income** which is finally taxed

This lesson deals with the methodology of computation of Gross Total Income, computation of deductions under Chapter VI-A and finding out the total income consisting of more than one heads of income. It may be noted as per the syllabus, the problem will not cover more than two heads of income and two deductions at a time although in actual practice more heads and more deductions may be needed.

2. CALCULATION OF NET TAXABLE INCOME

The sequence of determining the net taxable income is as below:

a) Assessment Year

Income should be computed for the ongoing assessment year ie 2012-13 and should cover all the receipts received in the previous year pertaining to the assessment year in question.

b) Previous Year

The previous year in relation to the assessment year is 2011-12 and the receipts during the year should be taken into consideration when computing the net taxable income.

c) Legal Status

The status of the person assessable to tax should be ascertained ie firm, company, individual, HUF, trust, etc.

d) Residential Status

The residential status of the person as per the above step should be ascertained to find out the taxable income. For eg. Income accruing outside India is not taxable for a non-resident.

e) Nature of Receipt

The nature of receipts has a bearing on the taxability of the receipt. Most capital receipts are not taxable except under the head "capital gains" and gifts now taxable u/s 56 as income from other sources..

f) Place of Accrual of Income

Income can accrue in India or outside India. Depending upon the residential status of the assessee, the net taxable income should be ascertained.

g) Exempt Income

The exempt incomes like share of profit from partnership firm, agricultural income, etc. should be excluded while calculating the gross total income.

h) Classification of Income

The scope of total income would include all the incomes as derived under the heads "salaries", "income from house property", "income from business or profession", "capital gains" and "income from other sources".

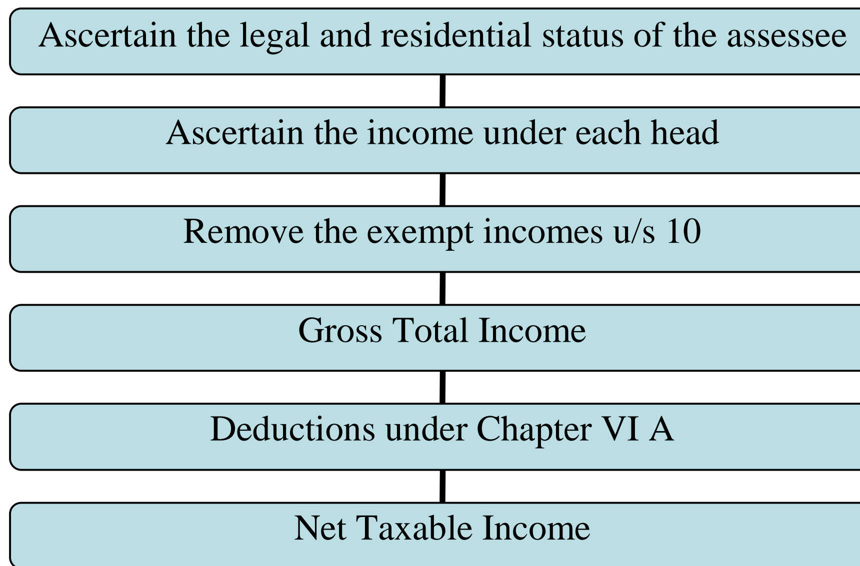
i) Deductions

Deductions under the chapter VI A should be allowed as a deduction from the gross total income to arrive at the net taxable income.

j) Total income

When Deductions under the chapter VI A are reduced from the gross total income, the final result is total income – popularly called as taxable income.

The key steps in ascertaining the net taxable income have been diagrammatically illustrated as below:



3. PERFORMA STATEMENT OF TAXABLE INCOME

Following is the statement of calculating the taxable income:

1. Income from Salary	XXX	
2. Income from House Property		XXX
3. Profit and Gain from Business and Profession	XXX	
4. Capital Gains		XXX
5. Income from Other Sources	XXX	
Gross Total Income (Total of 1 to 5)		*XXX*
Less: Deductions under Chapter-VIA		XXX
Total Income /**Taxable Income**		**XXX**

4. TYPICAL ILLUSTRATIONS

Illustration 1

Following is the Profit and Loss Account of Mangesh for the year ended 31st March, 2012.

Profit and Loss Account for the year ended 31st March, 2012.

Particulars	Rs.	Particulars	Rs.
To Salaries	2,10,000	By Gross Profit	4,18,000
To Rent	20,000	By Interest on Bank FD	8,000
To Postage	7,000	By Dividend from Indian Company	20,000
To Stationery and Printing	27,000		
To Advertising Expenses	20,000	By Dividend from Co-operative Bank	2,000
To Repairs to Office	22,700		
To Conveyance	17,000	By Winning from Lottery	15,000
To Income Tax	30,000	By Interest on Debentures of Limited Company	5,000
To Expenses in connection with scrutiny case of Income Tax	4,000		
To Fees paid to CA for Income Tax	10,000		
To Miscellaneous Expenses	25,000		
To Depreciation	5,000		
To Donation	20,000		
To Net Profit	50,300		
	4,68,000		4,68,000

Additional Information:

(1) Salaries include bonus due to employees Rs. 30,000 which was not paid before the due date of filing of Income Tax return.

(2) Rent is paid for the residential house of Mr. Mangesh.

(3) Repairs to office include a one-time cash payment of Rs. 20,000 on 18-08-2011

(4) Miscellaneous expenses include purchase of shares of an Indian company for Rs. 20,000.

(5) Donations include charity of Rs. 15,000 and Rs 5,000 given to GIC for maintenance of his handicapped brother.

(6) Depreciation as per Income tax rules is Rs. 4,000.

Compute the net taxable income of Mr. Mangesh for the AY 2012-13

Solution:

Name of the Assessee: **Mr. Mangesh** AY: **2012-13**
Status: **Individual** PY: **2011-12**
Residential Status: **Resident and Ordinarily Resident**

Computation of Total Income	**Rs**	**Rs**	**Rs**
I Income from Business			
Net Profit as per P/L Account		50,300	
Add: Disallowable Expenditure			
Bonus due but not paid u/s 43B	30,000		
Rent (Personal)	20,000		
Miscellaneous Expenses	20,000		
(purchase of shares)			
Income Tax	30,000		
Donation	20,000		
Depreciation	5,000	1,25,000	
Less: Income Considered Separately		1,75,300	
Interest on Bank FD	8,000		
Dividend from Indian Company	20,000		
Dividend from Co-operative Bank	2,000		
Winning from Lottery	15,000		
Interest on Debentures of Limited Co.	500	50,000	
		1,25,300	
Less: Depreciation as per rules		4,000	1,21,300
INCOME FROM BUSINESS			
II Income from Other Sources			
Interest on Bank FD		8,000	
Dividend from Indian Co. (exempt)		Nil	
Dividend from Co-operative Bank		2,000	
Winning from Lottery		15,000	
Interest on Debentures of Limited Co.		5,000	30,000
INCOME FROM OTHER SOURCES			1,51,300
GROSS TOTAL INCOME			
Less: Deductions under Chapter VI-A			
80-DD:Maintenance of handicapped dependent		50,000	50,000
TAXABLE INCOME			**1,01.300**

Note: for 80DD actual expenses not relevant.

Illustration 2

Sam provides the following Profit and Loss Account for the year ended 31st March, 2012.

Profit and Loss Account for the year ended 31st March, 2011.

Particulars	Rs.	Particulars	Rs.
To Salaries	1,30,000	By Gross Profit	7,67,000
To Rent	30,000	By UTI Dividend	9,000
To Entertainment Expenses	18,000	By Income from LIC Mutual Fund	5,000
To Printing & Stationery	25,000		
To Advertising Expenses	50,000	By Gift from Mother	5,000
To Motor Car Expenses	30,000	By Winning from Crossword Puzzle	12,000
To Personal Drawings	60,000		
To Income Tax	16,000	By Interest on NSC	3,000
To Embezzlement by an Employee	7,000		
To Staff Welfare Expenses	70,000		
To Depreciation	35,000		
To Donation	30,000		
To Net Profit	3,00,000		
	8,01,000		8,01,000

Additional Information:

(1) Depreciation as per Income tax rules is Rs. 38,000.

(2) Staff Welfare expenses include Rs. 20,000 for his own treatment.

(3) 50% of the rent is paid for his residential house

(4) Printing includes Rs. 5,000 paid for printing marriage cards for his daughter's marriage

(5) Assume donations do not qualify for deduction.

Compute the net taxable income of Mr. Sam for the AY 2012-13.

Solution:

Name of the Assessee: **Mr. Sam** AY: **2012-13**
Status: **Individual** PY: **2011-12**

Residential Status: Resident and Ordinarily Resident

Computation of Total Income	**Rs**	**Rs**	**Rs**
I Income from Business			
Net Profit as per P/L Account		3,00,000	
Add: Disallowable Expenditure			
Own Medical Expenses	20,000		
Rent (Personal)	15,000		
Printing of Marriage Cards	5,000		
Income Tax	16,000		
Donation	30,000		
Depreciation	35,000		
Drawings	60,000	1,81,000	
Less: Income Considered Separately	9,000	4,81,000	
UTI Dividend	5,000		
Income from LIC Mutual Fund	5,000		
Gift from Mother	12,000		
Winning from Crossword Puzzle	3,000		
Interest on NSC		34,000	
		4,47,000	
Less: Depreciation as per rules		38,000	4,09,000
INCOME FROM BUSINESS			
II Income from Other Sources			
UTI Dividend (exempt)			
Income from LIC Mutual Fund (exempt)		Nil	
		Nil	
Gift from Mother (exempt)		Nil	
Winning from Crossword Puzzle		12,000	
Interest on NSC		3,000	15,000
INCOME FROM OTHER SOURCES			4,24,000
GROSS TOTAL INCOME			3000
Less: Deductions under Chapter VI-A		3,000	**4.21,000**
80-C NSC Interest Re-invested			
TAXABLE INCOME			

Illustration 3

Mr S. V. Joshi is a Chartered Accountant, Following is his Receipt and Payments Account for the year ended 31st March, 2012.

Receipts	Rs.	Payments	Rs.
To Opening Cash & Bank Balance	70,000	By Office Rent	6,000
		By Printing and Stationery	5,000
To Fees from Clients (net)	3,60,000		
To Receipts from Articles written for financial Magazines	40,000	By Gifts to Staff	11,000
		By General Expenses	14,000
		By Motor Car Expenses	16,000
To Dividend from Indian Companies	5,000	By Telephone Expenses	12,000
		By Income Tax	40,000
To Interest on Bank SB Account	2,000	By Drawings	1,20,000
		By Motor Car Insurance	12,000
To Interest on PO Savings Account	3,000	By Conveyance Expenses	13,000
To Interest on FD with Banks	8,000	By Purchase of Accounting Software	19,000
To Interest on Government Securities	6,000	By LIC Premium paid	64,000
		By Salaries to Staff	12,000
To Sale of Motor Car	1,00,000	By purchase of Computer	50,000
		By Closing Cash & Bank Balance	2,00,000
	5,94,000		5,94,000

Additional Information:

(1) Computer was purchased on July 1, 2009 and depreciation is allowed @ 60% on the same.

(2) Opening WDV of Block of Motor Cars consisting of 2 Motor Cars was Rs. 2,50,000 and depreciation is allowed @ 20% on the same.

(3) Personal use of the Motor car is estimated to be 25%.

(4) Fees from clients are after TDS of Rs. 2,000.

(5) General expenses include a sum of Rs. 4,000 given to his daughter as birthday gift.

(6) Drawings include a sum of Rs. 30,000 given premium for self and family of Rs. 20,000 and Rs. 10,000 for his father, who is a senior citizen/.

Compute the net taxable income of Mr. S.V.Joshi for the AY 2012-13

Solution:

Name of the Assessee: **Mr. S. V. Joshi** AY: **2012-13**
Status: **Individual** PY: **2011-12**
Residential Status: **Resident and Ordinarily Resident**

Computation of Total Income	**Rs**	**Rs**
I Income from Business		
Fees from Clients	3,60,000	
Add: Tax Deducted at Sources	2,000	3,62,000
Less: Allowable Expenses		
Depreciation on Motor Car (WN 1)	22,500	
Motor Car Expenses @ 75%	12,000	
Office Rent	6,000	
Printing and Stationery	5,000	
General Expenses	10,000	
Motor Car Insurance @ 75%	9,000	
Telephone Expenses	12,000	
Conveyance Expenses	13,000	
Depreciation on Computer @ 60%	30,000	
Salaries to Staff	12,000	
Gifts to Staff	11,000	1,42,500
INCOME FROM BUSINESS		2,19,500
II Income from Other Sources		
Receipts for Writing Articles		
Interest on Fixed Deposit	40,000	
Interest on Government Securities	8,000	
Interest on SB Account	6,000	
Interest on PO Savings Account (exempt)	2,000	
Dividend from Indian Companies (exempt)	Nil	
INCOME FROM OTHER SOURCES	Nil	
GROSS TOTAL INCOME		56,000
Less: Deductions under Chapter VI-A		2,75,500
80-C Life Insurance paid		
80-D Medical insurance Premia :	64,000	
Rs 10,000 for father + Rs. 15,000 for self- =maximum	25,000	89,000
TAXABLE INCOME		
		1,86,500

Illustration 4

Compute total income of X from the particulars given below: Basic pay: Rs. 12,000 pm

Education allowance for one child: Rs. 300 pm

Bonus: Rs. 20,000

Salary in lieu of leave: Rs. 15,000

He contributed Rs. 18,400 to the recognized provident fund and an equal amount was contributed by his employer. He received Rs. 14,000 from bank as interest, dividend of Rs. 10,000 from a foreign company and winning from horse race of Rs. 42,500 (gross). He paid Rs. 500 professional tax.

Solution

Basic Salary 12,000 X 12)		1,44,000
Education allowance (300 X 12) Less: Exempt (100 X 12)	3,600 1,200	2,400
Bonus		20,000
Leave Encashment		15,000
		1,81,400
Less: Professional Tax		500
Income from Salaries		**1,80,900**
Bank Interest	14.000	
Dividend from foreign company	10,000	
Winnings from Horse Race	42,500	
Income from Other Sources		**66,500**
Gross Total Income		**2,47,400**

5. SELF ASSESSMENT QUESTIONS

1) Mr. Ram gives you the following Profit and Loss Account for the year ended 31st March, 2012

Profit and Loss Account for the year ended 31st March 2012

Particulars	Rs.	Particulars	Rs.
To Opening Stock	1,60,000	By Sales	18,50,000
To Purchases	14,05,000	By Closing Stock	1,08,500
To Salaries	1,84,350	By Winnings from Lottery	5,000
To Office Expenses	70,040	By Interest on fixed	15,000
To Office Rent	20,000	deposits with bank	
To Staff Welfare	13,000	By Interest on RBI Bonds	16,000
To Advertisement expenses	65,000	(exempt u/s 10)	
To Donations	5,000	By bad debts recovered	20,000
To R.D.D.	10,000	By dividend from Indian	9,000
To Mediclaim Insurance (paid	21,000	companies	
in cash)	10,000		
To Income Tax	8,000		
To Depreciation	20,000		
To Net Profit	32,110		
	20,23,500		20,23,500

Additional Information:

a) Advertisement expenses include Rs. 11,000/- for advertisement in a souvenir of a local political party and Rs. 20,000/- for introducing a new product in the market.

b) Donations are given for following purposes: Chief Minister’s Relief Fund Rs. 7,500/- ad donation of books to poor students Rs. 2,500/-.

c) On August 10, 2011 furniture of Rs. 20,000/- was purchased on credit the payment for which was made on April 2, 2012. The same was not recorded in the books of accounts. The rate of depreciation on furniture is 15% per annum. On other fixed assets, depreciation was charged exactly as per Income Tax Rules.

d) Bad debts recovered were allowed during the previous year 2003-2004.

You are required to compute the total income of Ram for AY 2012-13 assuming that Ram has paid LIC premium of Rs. 5,000. And interest of Rs 25,000 for educational loan of his son.

2) Sheela who is a suffering from a permanent disability, received the following emoluments from SWY Ltd, her employer for last 10 years during the year ended March 31, 2012:

Basic Salary (net of profession tax and tax deducted at source)

April 1, 2012 to September 30, 2012	Rs. 10,000 p.m.
October 1, 2012 to March 31, 2012	Rs. 12,000 p.m.
Tax deducted at source	
April 1, 2012 to September 30, 2012	Rs. 600 p.m.
October 1, 2012 to March 31, 2012	Rs. 700 p.m.
Profession tax deducted from Salary	Rs. 2,350 p.a.
Dearness Allowance	40% of basic salary
Entertainment Allowance	Rs. 500 p.m.
Actual amount spent for entertainment	Rs. 300 p.m.
Bonus for the year	Rs. 8,000/-
Conveyance Allowance	Rs. 1,000 p.m.
Actual amount spent out of conveyance allowance	Rs. 800 p.m.

Other Information.

1) Commission from employer is 1% of turnover of Rs. 10 lakhs achieved by him.

2) She needs a personal physical attendant whose salary of Rs. 2,000 p.m. was paid by the employer.

3) She paid Mediclaim insurance of Rs. 12,000/- for herself and Rs. 5,000/- for her brother. Statutory Provident Fund @ 10% of basic salary was deducted from her salary.

You are required to compute her total income for the AY 2012-13..

3) Mrs. Sweety aged 66 years took voluntary retirement on January 1, 2012 from a private bank after completing 26 years and 11 months of service. She furnishes you with the following information:

Basic Salary	Rs. 2,800 p.m.
Dearness Allowance	128% of basic salary
Conveyance Allowance	Rs. 900 p.m.
(actual conveyance expenses incurred Rs. 600 on official purpose)	
Gratuity	Rs.1,29,200/-
Commuted pension	Rs. 67,500/-
Leave Encashment	3 months basic salary
Uncommuted pension	Rs. 2,500 p.m.
Voluntary retirement compensation	Rs. 8,72,000/-
Profession tax paid	Rs. 1,200/-

After retirement, She delivers lectures as guest faculty in Indian Institute of Banking for which She receives honorarium of Rs. 22,000/-. She paid Mediclaim premium of Rs. 13,200/- by crossed cheque. She invests Rs. 50,000 in National Saving Certificates. She received gifts from her colleagues for Rs. 3,00,000 in January 2006.
She also donated Rs. 1,00,000 to poor boys.
Compute her net taxable income for the AY 2012-13.

4) Mr. Krishna is a proprietor of a business. The following is the Profit and Loss Account of his business for the year ended March 31, 2012. You are required to compute his total income for the AY 2012-13.

Particulars	Rs.	Particulars	Rs.
To Opening Stock	2,34,000	By Sales	12,40,000
To Purchase	10,00,000	By Closing Stock	2,05,000
To Office Salaries	57,000	By Income Tax Refund (including interest Rs. 2,000)	15,000
To Proprietor's Salaries	30,000		
To Bad Debts	25,000		
To Advertisement	10,500	By Dividend from UTI	20,000
To Fire Insurance Premium	4,500	By Dividend from Y Ltd (an Indian Company)	25,000
To Conveyance Expenses	6,000		
To Interest on Proprietor's Funds	25,000	By Interest on PPF	5,000
		By Lottery prize received	10,000
To Medical Expenses (of Krishna)	20,000		
To General Expenses	35,000		
To Wealth Tax paid	5,000		
To Residential Telephone expenses	14,000		
To Depreciation	30,000		
To Net Profit	20,000		
	15,20,000		15,20,000

Additional Information

a) The residential telephone is used half the time for office work.

b) Purchases include Rs. 1,00,000/- paid for cash purchases, exceeding the limits prescribed under Section 40A(3).

c) General expenses include advance income tax of Rs. 10,000/- paid during the year and Rs. 500/- for purchase of lottery tickets.

d) Depreciation allowable as per Income Tax Rules Rs. 25,000/-

e) Agricultural income Rs.70,000.

Compute the total income of Mr. Krishna for the A.Y. 2012-13

5) Rabbi, a person with disability, furnishes the following information regarding his house property:

Particulars	HOUSE I	HOUSE II
Fair Rent	40,000	60,000
Municipal Valuation	55,000	50,000
Rent received	60,000	--
Municipal tax:		
(a) Paid by the tenant	4,000	--
(b) Paid by Rabbi	6,000	5,000
Interest on capital borrowed (due but not paid) for the purpose of construction of house property	6,000	13,000
Ground Rent	2,000	--
Insurance premium paid	1,500	--
Other information:		
(i) Interest from debentures in Y Ltd	12,000	--
(ii) Dividend from UTI	5,000	--
(iii) Bank interest from SBI	3,500	--
(iv) Winning from lottery	28,000	--
(v) Interest from Post Office Savings Account	5,000	--
(vi) Dividend from a co-operative society	5,000	--

Compute the total taxable income of Rabbi for the AY 2012-13