# Elements of Income Tax

By: Neena Kaushik

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# CONTENTS

*S.No.* *Page*

1. Basic Concepts-I .......... 1
2. Basic Concepts-II .......... 8
3. Residential Status and Tax Liability .......... 15
4. Exempted Incomes Under Section-10 .......... 26
5. Salaries-I .......... 32
6. Salaries-II .......... 44
7. Salaries-III .......... 63
8. Income From House Property .......... 73
9. Capital Gains .......... 84
10. Income From Other Sources .......... 96
11. Deductions from Gross Total Income .......... 113
12. Computation of Total Income .......... 126
13. Filing of Return and Tax Authorities .......... 135

# Sample Preview
# of
# The Chapter

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# ELEMENTS OF INCOME TAX

FUNDAMENTALS

## Basic Concepts-I

### INTRODUCTION

There are broadly two kinds of taxes, Direct Taxes and Indirect Taxes. Direct taxes are those taxes in which the person who pays the tax also bears the burden of the tax. One of the most important direct taxes is the income tax which is imposed by the central government. It is a tax which is paid by individuals, the Hindu Undivided Family, firms and corporate based on the incomes that they earn during the previous year. In this context, we have to know the meanings of various terms that will be used, for example, what is an assessment year ,what constitutes income, which year is the previous year and who are supposed to pay income tax, etc. In this chapter, we shall study about the developments in income tax over the years and how the Income Tax Act defines various terms related to taxation of income.

### CHAPTER AT A GLANCE

**BROAD MECHANISM OF INCOME TAX IN INDIA**

It was after the revolt of 1857 that the British government passed the Income Tax Act,1886 for the first time to raise money for meeting the huge war expenditure that it had to bear. This Act had many loopholes which became evident during the first world war when the government again had to face financial difficulties. After a lot of detailed study, a modified Act was brought to force in 1922 which was in force for 40 years.

After independence it was felt that the law was unsatisfactory and major changes were required in the Act. A draft bill was submitted by the Law Commission in 1958. A Committee known as Direct Taxes Administration Committee was formed in the same year with Mahabir Tyagi as its chairman. This committee analysed the direct tax structure and submitted a draft. The old Act was replaced by the new Income Tax Act from 1 April, 1962.

The Central Board of Direct Taxes (CBDT) administers the Act under the supervision of the Ministry of Finance. It also makes rules regarding the administration of the Act which are known as The Income Tax Rules, 1962. They contain various forms and numerous details

From time to time the CBDT issues circulars for the tax payers and the income tax department to inform them of all the latest changes and modifications. To keep abreast with these changes, one can read tax journals and other tax publications.

**The Finance Act**

The budget presented by the government on the last day of February every year is a statement of the estimated receipts and expenditure of the government in the coming financial year. In the budget the finance ministry gives abroad idea to the public regarding its finances. The government also presents the finance bill in the parliament, when it is passed the various tax proposals regarding direct and indirect taxes become laws. The tax rates for the coming financial year are fixed in this bill and the tax department levies tax according to it.

Thus to know about the tax structure one has to update himself with the latest Finance Act also.

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**Scheme of Income Tax–An Overview**

All those individuals whose income is more than a specified minimum limit fixed by the budget every year are required to pay income tax. According to the latest budget (The Finance Act), 2013 the exemption limit for Income Tax has been fixed at Rs. 2,00,000 for an individual or HUF, Rs. 2,50,000 for individuals more than 60 years and less than 80 years and 5,00,000 for residents above 80 years for assessment year 2014-15.

The Income Tax Act has categorized the incomes of people into five types so that the tax structure can be made more diverse and a set standard may be followed: *(i)* salaries *(ii)* income from house property, profits and gains from business or profession, capital gains and income from other sources. From 1989-90, 'income from interest on securities' which was a separate head of income earlier, has become taxable under the head 'profits and gains of business or profession' or 'income from other sources' based on whether the securities are a stock-in-trade or an investment. The Act provides how to calculate these incomes.

The Income Tax Rules and the Finance Act has detailed provision for all situations that the administrators may face while implementing the Income Tax Law.

The Income Tax Act, 1961 is applicable in all the states and Union Territories of the country. It has 400 sections, numbering from 1 to 298, and 12 schedules. Schedules number six, eight, nine and twelve have been removed.

**CONCEPT OF INCOME**

To calculate the income of an individual, it is important to know exactly what is income and how it is calculated and what are its principles. The following chapters will be dealing with all this:

**Definition of Income**

Section 2(24) of the Income Tax Act,1961 defines "Income" which has a very broad scope. It cannot be defined in totality but the Income Tax Act specifies what is included in the term income to define it. It has to be remembered that this definition is income from the point of view of taxation only. According to Section 2(24) Income Tax Act, income includes the following:

*(a)* Profits and gains
*(b)* Dividends
*(c)* Voluntary contributions received by trust, religious or charitable or scientific or sports organization. If the contribution specifically forms a part of the trust funds, it is not considered as income.
*(d)* The perquisite or profit in lieu of salary.
*(e)* Special allowances or facilities that the individual gets from his company to meet certain expenditure that he undertakes to perform the duty allocated to him, for example, expenses to entertain clients.
*(f)* Allowances that the company provides to an employee to cover his accommodation expenses or the enhanced living expenses.
*(g)* Any benefit an employee gets from an important stake owner like director of a company or by their relatives.
*(h)* The value of all benefits a trustee receives from a trust in any form, cash or kind is added to the taxable income of the person.
*(i)* Compensation made to an employee on his termination and income generated by any trade, professional or similar association for services rendered and chargeable profit under Section 59.
*(j)* The value of any perquisite generated by a business or profession under Section 28 *(iv)*.
*(k)* Capital gains from sale of a capital asset.
*(l)* Profits generated from insurance sold by an insurance company or by cooperatives calculated according to Section 44.
*(m)* Any amount such as profits, or recovery of losses, expenses or outstanding amount in trade in which the individual was granted deduction in the previous year or deemed profits will be taxed this year.
*(n)* Profit on sale of import licence issued under Imports (Control) Orders,1955.
*(o)* Monetary grants received by a person against exports under any scheme of the central government.
*(p)* Any customs or excise duty repayable to a person in lieu of exports.
*(q)* Any money won from games like lottery, crossword puzzles, races or card games, etc.
*(r)* Any contribution by employers to the provident fund or such welfare schemes for their employees.

**Basic Principles**

It is not possible to have a complete definition of the term 'income'. It is quite a wide concept and through the act we only get to know what all items are to be included in the income for taxation purpose. Because comprehensive definition is not available, mostly the income tax department depends upon the judgements given by the high courts and the Supreme Court.

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All that money received by an individual which conforms to the guidelines of the high courts and the Supreme Court are classified as income, not all money receipts. The following are broad principles which are followed to calculate income:

1. Income would be a regular money receipt from a fixed source at fixed periods of time, say monthly. It is not necessary that the source is productive but it should generate income on a regular basis.
2. Income may be money or any commodity which can be valued in terms of money, generated by the use of real or personal property, i.e. all receipts whether in cash or kind are considered income.
3. Though the income must be a receipt which the individual expects from time to time with some regularity, even a single receipt would be called income.
4. Even money yet to be received but which is due will be taken as income.
5. All exempted amount of money is also called income.
6. All real incomes are income, not fictional or technical incomes.
7. Any money received out of love or within the house for no productive reason, for e.g. pocket money are not considered income. Income must be received from an external source.
8. All legal as well as illegal receipts. Income does not include only that coming from legal sources. People have to pay taxes on incomes generated in illegal ways as well. But paying tax does not mean the illegal income is free from punishment.

**DEFINITION OF PERSON**

Who is the person whom we refer to in taxation? The term person is defined in Section 2(31) of the Act. It specifies who the entities that will be called a person are. It is *(a)* An individual *(b)* A Hindu Undivided Family *(c)* A company *(d)* A Firm *(e)* An association of persons or a body of individuals whether they have been incorporated or not *(f)* A local authority, and *(g)* Any artificial judicial person, i.e. any body that has the existence of an individual because it has been given legal status of an individual, for example, a joint stock company.

Thus, a person, according to Income Tax Act is not just an individual but carries a broader definition. All those people and associations having the legal status of being an individual are supposed to pay income tax under the Income Tax Act, 1961.

**DEFINITION OF ASSESSEE**

Who is an assessee? It has been defined in Section (7) of the Income Tax Act,1961."Assessee is the person who is supposed to pay tax or any other amount according to the Income Tax Act.

The following will be called an assessee:

*(i)* All those whose income is being assessed for tax purposes.

*(ii)* All those whose incomes can be assessed in respect of other people.

*(iii)* All those who are supposed to get income tax refund.

*(iv)* All people who are considered assessee under this Act.

*(v)* All people who have defaulted under some provision of this Act and are supposed to pay tax.

Who is a defaulter assessee? A person who is supposed to deduct tax at the source of income but has not done it; a person who has deducted the tax but has not paid it to the government; and a person who has not made timely payment of advanced income tax. Those people were supposed to pay taxes but have not paid them and are hence called defaulters.

This wide definition of income tax encompassed all those who have even slight chances of being called an assessee.

**PERMANENT ACCOUNT NUMBER**

You must be aware of PAN which is a unique number given to tax assesses by which they can be easily identified. Even if the assessee changes his address or any other particular related to him changes, the PAN will not change, so it is very much an identity of an individual.

Any tax paying individual is supposed to hold a PAN and in case of not having one has to apply to the assessing officer in order to be able to file his returns.

All those people who are earning more than Rs. 50,000 in any business or service are required to acquire a PAN in case they do not have one.

All people liable to pay taxes are allotted a PAN by the Income Tax Assessing Officer. This Pan has to be quoted everywhere by the assessee, in filing his returns or filing any form or making any correspondence whatsoever with the Income Tax office.

Those people who have not been allotted a PAN can use their GIR number if they have one for all the purposes where PAN was required. (From 2005 it is mandatory to quote PAN).

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**ASSESSMENT YEAR**

The definition of the assessment year is given in Section 2(9) of the Income Tax Act, 1961. The assessment year is the year in which the previous year's taxable income of the assessee is being assessed. For example, the current year is 2013-2014. This is the assessment year. In this year, last year's income, i.e income of 2012-2013 is calculated for taxation purposes. The calculation is done for the duration 1, April, 2012 to 31, March 2013. The year 2013-2014 is the assessment year or the financial year in which the assessee pays the tax for the previous year. There are some exceptions to the previous years' income being taxed only which will be discussed further.

**PREVIOUS YEAR**

The year for which the salary is being calculated is the previous year and the year in which it is assessed is the assessment year. All government business is conducted in this previous year between April 1 of last year and March 31 of this year also known as the fiscal year. Before 1989-90, the assessee could consider any 12 months as the assessment year, it may be from a Diwali to the next Diwali or from one Dussehra to another Dussehra or any other year. From 1.4.1989. uniformity has been maintained and the assessment year is now from 1 April to March 31. The following provisions of Section 3 after amendment in 1989-90 are as follows:

1. The previous year refers to the year just preceding the assessment year.
2. Previous year means the 12 months which just ends on any day during the financial year immediately before 1 April of the assessment year.

If in the previous year the assessee had different sources of income, he has to make separate assessment for each source in the assessment year . He cannot club all the sources. The period for any source, would be a period of twelve months or less. The assessee cannot make a uniform accounting year. If the previous year exceeded 12 months, there could be changes in the monetary limit, depreciation allowance or rate of tax according to the tenth schedule.

If the assessee has set up a new business in the previous year before April 1, 2012 and after March 31, 2011, the assessment of his business would exceed twelve months extending up to March 31, 2013. The period of previous year would be from the starting date of the business in 2011-12 to March 31, 2013. For example:

*(a)* If Mr Das has founded a new business on 1.10. 2011, and does not close his financial year on March 31, 2012 but continues up to March 31, 2013, his period of assessment would be 18 months.

*(b)* If Ritu Beri was adopting 1 January to December 31 as financial year before 1991, and then started following the uniform year of April 1-March 31, her year of assessment would be from January 1, 1991 to March 31, 1992, which would be 15 months.

The above period was referred to as the transitional period. Due to the transition, the previous year's duration became more than 12 months due to which the assessee might not get the benefit of exemptions, and other benefits. Such cases are dealt with in schedule 10 which allowed for the exemption limits to be increased.

Presently, the previous year cannot exceed 12 months. For example, if a new business has been set up on November 1, 2011 and assessment year is 2012-13, the previous year would be 1, 2011 to 31 March 2012, i.e. 5 months.

**TAXATION OF THE PREVIOUS YEAR'S INCOME DURING THE SAME YEAR**

In case of all incomes, taxes for the previous year are charged in the assessment year. But there are some incomes which have to be charged tax in the same year. These are:

***(a)* Income of non-resident shipping companies:** According to Section 172 of the Income tax Act 1962, master of the non-resident shipping companies have to provide to the concerned assessing officer return of the full amount paid or payable to the owner for carrying passengers, livestock, etc. before departure from any Indian port. The assessing officer would immediately assess the income and calculate the payable tax. 7.5% of the income from the freight is considered as the assessee's income and charged with tax in the same year.

***(b)* Income of persons leaving India:** According to Section 174, if an assessing officer feels that an individual leaving India is not going to come back, he can charge tax on the person before he leaves. In this case, the previous year will be calculated from April 1 till his date of departure and he has to pay the tax immediately.

***(c)* Income of persons trying to Alienate their assets:** If the assessing officer discovers that some people are trying to sell a property in the same year in which it was bought to avoid the payment of tax, he

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