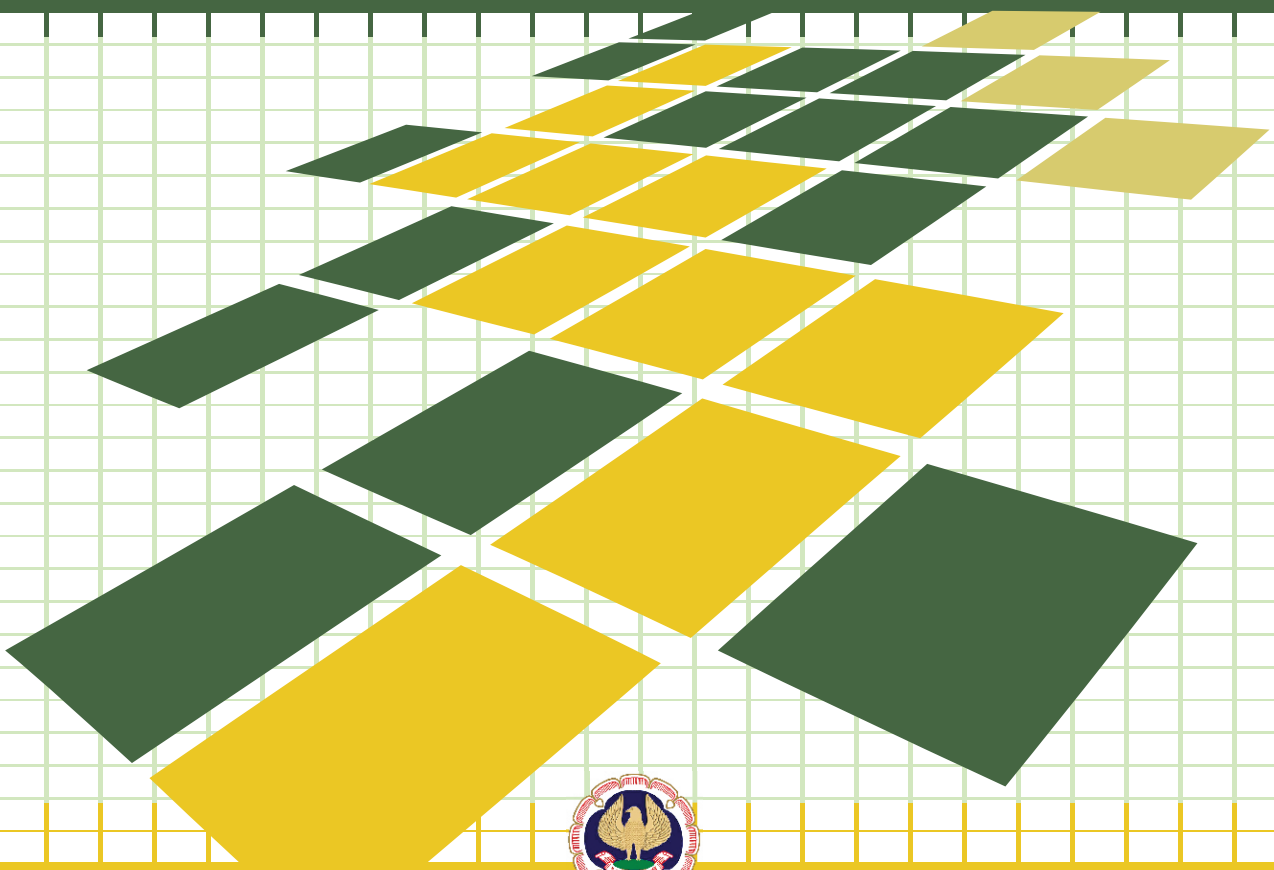
FINAL (NEW) COURSE

DIRECT TAX LAWS

Vol. 1

A.Y. 2010-11



Board of Studies
The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

FINAL COURSE STUDY MATERIAL

PAPER 7

Direct Tax Laws

Assessment Year 2010-11

[Relevant for students appearing for
May 2010 and November 2010 examinations]

Volume – 1

BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

This study material has been prepared by the faculty of the Board of Studies. The objective of the study material is to provide teaching material to the students to enable them to obtain knowledge and skills in the subject. Students should also supplement their study by reference to the recommended text book(s). In case students need any clarifications or have any suggestions to make for further improvement of the material contained herein they may write to the Director of Studies.

All care has been taken to provide interpretations and discussions in a manner useful for the students. However, the study material has not been specifically discussed by the Council of the Institute or any of its Committees and the views expressed herein may not be taken to necessarily represent the views of the Council or any of its Committees.

Permission of the Institute is essential for reproduction of any portion of this material.

© **The Institute of Chartered Accountants of India**

All rights reserved. No part of this book may be reproduced, stored in a retrieval system, or transmitted, in any form, or by any means, electronic, mechanical, photocopying, recording, or otherwise, without prior permission, in writing, from the publisher.

Website	:	www.icai.org
E-mail	:	bosnoida@icai.org
Department/ Committee	:	Board of Studies
ISBN No.	:	978-81-8441-078-5
Published by	:	The Publication Department on behalf of The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No.7100, Indraprastha Marg, New Delhi-110 002,India. Typeset and designed at Board of Studies.
Printed by	:	Sahitya Bhawan Publications, Hospital Road, Agra 282 003. March/ 2010 /15,000 Copies (Reprint)

PREFACE

Direct tax laws and Indirect tax laws are important elements of the core competence areas of the Chartered Accountants. A thorough knowledge of direct tax laws and indirect tax laws is, therefore, necessary for the students of the CA Final course. In the new Final course, "Direct Tax Laws" constitutes Paper–7. Students are expected to acquire advanced knowledge of the provisions of direct tax laws after undergoing this course and apply such knowledge to various situations in actual practice.

The first part of this study material deals with income-tax. There are 28 chapters under income-tax. The inter-relationship between accounting and taxation is discussed in chapter 12. The concept and significance of "ethics" in taxation has been discussed in the chapter of "Tax Planning". The second part of this study material is on wealth-tax. There are 3 chapters under wealth-tax. The subject matter in this study material is based on the law as amended by the Finance (No.2) Act, 2009. In this study material, efforts have been made to present the complex direct tax laws in a lucid manner. The latest amendments have been given in italics. Chapters are organised in a logical sequence to facilitate easy understanding. Another helpful feature in this study material is the addition of self-examination questions at the end of each chapter, which will be useful to test understanding of the provisions discussed in the chapter. Answers have been given in respect of those questions which are based on judicial decisions or involving legal interpretations.

The taxation laws in our country undergo many amendments. In order to help the students to update their knowledge relating to the statutory developments in the field of direct and indirect tax laws, the Board of Studies brings out, every year, a "Supplementary Study Paper" containing all the amendments in direct and indirect taxes. This is an essential read for all our students. Another important publication, "Select cases in Direct and Indirect Taxes – An essential reading for the final course", is meant for updating the knowledge regarding judicial decisions.

A word of advice to the students – please make it a habit of referring to the bare acts as often as possible. This will not only facilitate the process of understanding the law and the sequence of sections in these Acts, but will also equip them with the professional expertise that is expected.

Study Material of Direct Tax Laws is made in two volumes for ease of handling by the students. Volume – 1 contains Chapters 1 – 14 of Income Tax, and Volume – 2 contains Chapters 15 – 28 of Income Tax and Chapters 1 – 3 of Wealth Tax.

Finally, we would welcome suggestions to make this study material more useful to the students. In case of any doubt, students are welcome to write to the Director of Studies, The Institute of Chartered Accountants of India, A-94/4, Sector -58, Noida 201 301, India.

SYLLABUS

PAPER – 7 : DIRECT TAX LAWS

(One paper — Three hours – 100 Marks)

Level of Knowledge: Advanced knowledge

Objectives:

(a) To gain advanced knowledge of the provisions of direct tax laws,

(b) To acquire the ability to apply the knowledge of the provisions of direct tax laws to various situations in actual practice.

Contents:

I. The Income-tax Act, 1961 and Rules thereunder (90 marks)

II. The Wealth-tax Act, 1957 and Rules thereunder (10 marks)

While covering the direct tax laws, students should familiarise themselves with considerations relevant to tax management. These may include tax considerations with regard to specific management decisions, foreign collaboration agreements, international taxation, amalgamations, tax incentives, personnel compensation plans, inter-relationship of taxation and accounting, with special reference to relevant accounting standards and other precautions to be observed to maximise tax relief. Further, they should have a basic understanding about the ethical considerations in tax management and compliance with taxation laws.

Note – If new legislations are enacted in place of the existing legislations relating to income tax and wealth tax, the syllabus will accordingly include such new legislations in the place of the existing legislations with effect from the date to be notified by the Institute.

Volume – 1

INCOME TAX

CONTENTS

CHAPTER 1 : BASIC CONCEPTS

1.1 Overview of Income-tax law in India 1.1

1.2 Charge of income-tax 1.2

1.3 Rates of tax 1.3

1.4 Concept of income 1.6

1.5 Total income and tax payable 1.7

1.6 Important definitions 1.12

1.7 Other basic concepts 1.27

CHAPTER 2 : RESIDENCE AND SCOPE OF TOTAL INCOME

2.1 Residential status 2.1

2.2 Scope of total income 2.6

2.3 Deemed receipt and accrual of income in India 2.7

2.4 Meaning of “Income received or deemed to be received” 2.8

2.5 Meaning of income “accruing” and “arising” 2.8

2.6 Income deemed to accrue or arise in India 2.9

CHAPTER 3 : INCOMES WHICH DO NOT FORM PART OF TOTAL INCOME

3.1 Introduction 3.1

3.2 Incomes not included in total income 3.1

3.3 Tax holiday for industrial units in FTZ 3.57

3.4 Tax holiday for newly established units in SEZ 3.62

3.5 Tax holiday for 100% EOUs 3.66

3.6 Charitable or religious trusts and institutions 3.69

CHAPTER 4 : INCOME FROM SALARIES

4.1 Salary 4.1
4.2 Definition of salary 4.2
4.3 Basis of charge 4.3
4.4 Place of accrual of salary 4.3
4.5 Profits in lieu of salary 4.4
4.6 Advance salary 4.5
4.7 Loan or advance against salary 4.5
4.8 Salary arrears 4.5
4.9 Annuity 4.5
4.10 Gratuity 4.6
4.11 Pension 4.6
4.12 Leave salary 4.6
4.13 Retrenchment compensation 4.6
4.14 Compensation received on voluntary retirement 4.6
4.15 Provident fund 4.6
4.16 Approved superannuation fund 4.11
4.17 Salary from United Nations Organisation 4.11
4.18 Allowances 4.12
4.19 Perquisites 4.13
4.20 Valuation of perquisites 4.20
4.21 Deductions from salary 4.36
4.22 Deduction under section 80C 4.38
4.23 Relief under section 89 ..... 4.38

CHAPTER 5 : INCOME FROM HOUSE PROPERTY

5.1 Chargeability 5.1
5.2 Conditions for chargeability 5.1
5.3 Composite rent 5.2

5.4 Income from house property situated outside India 5.3
5.5 Determination of annual value 5.3
5.6 Deductions from annual value 5.7
5.7 Computation of income from house property for different categories of property 5.9
5.8 Inadmissible deductions 5.19
5.9 Taxability of recovery of unrealised rent and arrears of rent received 5.19
5.10 Treatment of income from co-owned property 5.19
5.11 Treatment of property owned by a partnership firm 5.20
5.12 Deemed ownership 5.20
5.13 Cases where income from house property is exempt from tax 5.21

CHAPTER 6 : PROFITS AND GAINS OF BUSINESS OR PROFESSION

6.1 Meaning of “Business”, “Profession” and “Profits” 6.1
6.2 Income chargeable under this head 6.2
6.3 Speculation business 6.5
6.4 Computation of income from business 6.7
6.5 Admissible deductions 6.8
6.6 Inadmissible deductions 6.64
6.7 Expenses or payments not deductible in certain circumstances 6.68
6.8 Profits chargeable to tax 6.75
6.9 Deduction in case of business for prospecting etc. for mineral oil 6.76
6.10 Changes in rate of exchange of currency 6.78
6.11 Deductions allowable only on actual payment 6.79
6.12 Computation of cost of acquisition of certain assets 6.81
6.13 Income of Public Financial Institutions 6.82
6.14 Insurance business 6.82
6.15 Special provisions in the case of certain associations 6.83
6.16 Compulsory maintenance of accounts 6.83

6.17 Compulsory audit of accounts 6.85
6.18 Profits and gains of civil construction etc. 6.87
6.19 Profits and gains of business of plying, hiring or leasing goods carriages 6.89
6.20 Profits and gains of retail trade business 6.91
6.21 Profits and gains of shipping business of non-residents 6.91
6.22 Taxable income from exploration of mineral oil 6.92
6.23 Profits and gains from operation of aircraft by non-residents 6.92
6.24 Profits and gains of foreign companies engaged in the business of civil construction etc. in certain turnkey power projects 6.94
6.25 Special provisions for computing income by way of royalties etc. in case of non-residents 6.94
6.26 Method of computing deduction in the case of business reorganisation of co-operative banks 6.95
6.27 Computation of business income where income is partly agricultural and partly business in nature 6.99

CHAPTER 7 : CAPITAL GAINS

7.1 Introduction 7.1
7.2 Capital asset 7.1
7.3 Short-term and long-term capital assets 7.3
7.4 Transfer: what it means 7.5
7.5 Scope and year of chargeability 7.6
7.6 Capital gains on distribution of assets by companies in liquidation 7.10
7.7 Capital gains on buyback, etc. of shares 7.11
7.8 Transactions not regarded as transfer 7.11
7.9 Important definitions 7.15
7.10 Withdrawal of exemption in certain cases 7.17
7.11 Mode of computation of capital gains 7.18
7.12 Ascertainment of cost in specified circumstances 7.20
7.13 Cost of improvement 7.23

7.14 Cost of acquisition 7.26
7.15 Computation of capital gains in case of depreciable asset 7.32
7.16 Capital gains in respect of slump sales 7.33
7.17 Special provision for full value of consideration in certain cases 7.34
7.18 Advance money received 7.35
7.19 Exemptions of capital gains 7.37
7.20 Reference to valuation officer 7.46
7.21 Short term capital gains tax in respect of equity shares/units of an equity oriented fund 7.46
7.22 Tax on long-term capital gains 7.47
7.23 Exemption of long term capital gains on sale of equity shares/units of an equity oriented fund 7.48
7.24 Securities lending and borrowing scheme 7.49

CHAPTER 8 : INCOME FROM OTHER SOURCES

8.1 Introduction 8.1
8.2 Incomes chargeable under this head 8.1
8.3 Bond washing transactions and dividend stripping 8.6
8.4 Applicable rate of tax in respect of casual income 8.7
8.5 Deductions allowable 8.7
8.6 Deductions not allowable 8.8
8.7 Deemed income chargeable to tax 8.9
8.8 Method of accounting 8.9

CHAPTER 9 : INCOME OF OTHER PERSONS INCLUDED IN ASSESSEE'S TOTAL INCOME

9.1 Clubbing of income - An introduction 9.1
9.2 Transfer of income without transfer of the asset 9.1
9.3 Income arising from revocable transfer of assets 9.1
9.4 Exceptions where clubbing provisions are not attracted even in case of revocable transfer 9.2

9.5 Clubbing of income arising to spouse 9.2
9.6 Transfer of assets for the benefit of the spouse 9.5
9.7 Income arising to son's wife from the assets transferred without adequate consideration by the father-in-law or mother-in-law 9.6
9.8 Transfer of assets for the benefit of son's wife 9.6
9.9 Clubbing of minor's income 9.6
9.10 Cross transfers 9.7
9.11 Conversion of self-acquired property into the property of a HUF 9.8
9.12 Income includes loss 9.8
9.13 Distinction between section 61 and section 64 ..... 9.8
9.14 Liability of person in respect of income included in the income of another person 9.8

CHAPTER 10 : AGGREGATION OF INCOME, SET-OFF AND CARRY FORWARD OF LOSSES

10.1 Aggregation of income 10.1
10.2 Concept of set off and carry forward of losses 10.1
10.3 Inter source adjustment 10.1
10.4 Inter head adjustment 10.2
10.5 Set-off and carry forward of loss from house property 10.4
10.6 Carry forward and set-off of business losses 10.4
10.7 Carry forward and set-off of accumulated business losses and unabsorbed depreciation allowance in certain cases of amalgamation/demerger, etc. 10.6
10.8 Set-off of losses of a banking company against the profits of a banking institution under a scheme of amalgamation 10.9
10.9 Carry forward and set-off of accumulated losses and unabsorbed depreciation in business reorganisation of co-operative banks 10.9
10.10 Losses in speculation business 10.11
10.11 Carry forward and set-off of losses by specified business 10.12
10.12 Losses under the head 'capital gains' 10.12

10.13 Losses from the activity of owning and maintaining race horses 10.13
10.14 Carry forward and set off of losses in case of change in constitution of firm or succession 10.15
10.15 Carry forward and set-off of losses in case of closely held companies 10.15
10.16 Order of set-off of losses..... 10.16

CHAPTER 11 : DEDUCTIONS FROM GROSS TOTAL INCOME

11.1 General Provisions 11.1
11.2 Deductions in respect of payments 11.3
11.3 Deductions in respect of incomes 11.22
11.4 Other deductions 11.54

CHAPTER 12 : INTER-RELATIONSHIP BETWEEN ACCOUNTING AND TAXATION

12.1 Recognition of accounting principles by judicial forums while settling tax disputes 12.1
12.2 Accounting Standards and Income-tax law - Convergence and divergence 12.3
12.3 Treatment of income-tax expense under Accounting Standards 12.9
12.4 Relevance of method of accounting under the Income-tax Act 12.17
12.5 Valuation of inventory [Section 145A vs. AS-2] 12.23
12.6 Requirement of compulsory maintenance of prescribed books of account under the Income-tax law 12.25
12.7 Relevance of profit and loss account prepared as per Companies Act for computing book profit for levy of MAT..... 12.27
12.8 Conclusion 12.27

CHAPTER 13 : ASSESSMENT OF VARIOUS ENTITIES

13.1 Assessment of individuals 13.1
13.2 Assessment of Hindu Undivided Families 13.6
13.3 Assessment of local authority..... 13.14
13.4 Assessment of firms/LLPs and their partners 13.15
13.5 Assessment of companies..... 13.28

13.6 Assessment of co-operative societies 13.70
13.7 Assessment of mutual concerns 13.71
13.8 Liability in special cases 13.73

CHAPTER 14 : TAX PLANNING AND ETHICS IN TAXATION

14.1 Basic concepts 14.1
14.2 Tax planning considerations in respect of salary income 14.26
14.3 Tax planning considerations in relation to business 14.29
14.4 Ethics in Taxation 14.57

CHAPTERS 15 – 28 of Income Tax and CHAPTERS 1 – 3 of Wealth Tax are available in Volume – 2.

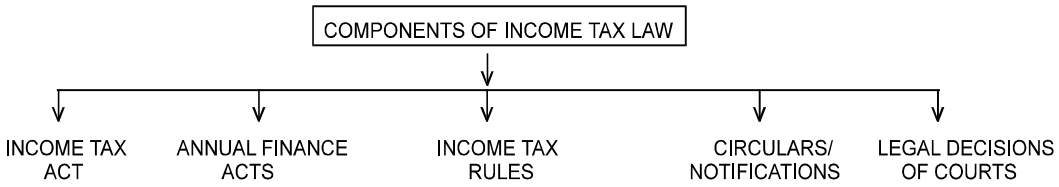
INCOME TAX

1

BASIC CONCEPTS

1.1 OVERVIEW OF INCOME-TAX LAW IN INDIA

Income-tax is a tax levied on the total income of the previous year of every person. A person includes an individual, Hindu Undivided Family (HUF), Association of Persons (AOP), Body of Individuals(BOI), a firm, a company etc. Income-tax is the most significant direct tax. The income-tax law in India consists of the following components–



The various instruments of law containing the law relating to income-tax are explained below:

Income-tax Act

The levy of income-tax in India is governed by the Income-tax Act, 1961. In this book we shall briefly refer to this as the Act. This Act came into force on 1st April, 1962. The Act contains 298 sections and XIV schedules. These undergo change every year with additions and deletions brought about by the Finance Act passed by Parliament. In pursuance of the power given by the Income-tax Act, rules have been framed to facilitate proper administration of the Income-tax Act.

The Finance Act

Every year, the Finance Minister of the Government of India presents the Budget to the Parliament. Part A of the budget speech contains the proposed policies of the Government in fiscal areas. Part B of the budget speech contains the detailed tax proposals. In order to implement the above proposals, the Finance Bill is introduced in the

Parliament. Once the Finance Bill is approved by the Parliament and gets the assent of the President, it becomes the Finance Act.

Income-tax Rules

The administration of direct taxes is looked after by the Central Board of Direct Taxes (CBDT). The CBDT is empowered to make rules for carrying out the purposes of the Act. For the proper administration of the Income-tax Act, the CBDT frames rules from time to time. These rules are collectively called Income-tax Rules, 1962. It is important to keep in mind that along with the Income-tax Act, these rules should also be studied.

Circulars and Notifications

Circulars are issued by the CBDT from time to time to deal with certain specific problems and to clarify doubts regarding the scope and meaning of the provisions. These circulars are issued for the guidance of the officers and/or assessees. The department is bound by the circulars. While such circulars are not binding the assessees they can take advantage of beneficial circulars.

Case Laws

The study of case laws is an important and unavoidable part of the study of income-tax law. It is not possible for Parliament to conceive and provide for all possible issues that may arise in the implementation of any Act. Hence the judiciary will hear the disputes between the assessees and the department and give decisions on various issues. The Supreme Court is the Apex Court of the country and the law laid down by the Supreme Court is the law of the land. The decisions given by various High Courts will apply in the respective states in which such High Courts have jurisdiction.

1.2 CHARGE OF INCOME-TAX

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

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

(ii) The charge is on every person specified under section 2(31);

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

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

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

1.3 RATES OF TAX

Income-tax is to be charged at the rates fixed for the year by the annual Finance Act. Section 2 read with Part I of the First Schedule to the Finance (No.2) Act, 2009 specifies the rates at which income-tax is to be levied on income chargeable to tax for the A.Y. 2009-10. Part II lays down the rate at which tax is to be deducted at source during the financial year 2009-10 i.e. A.Y. 2010-11 from income subject to such deduction under the Act; Part III lays down the rates for charging income-tax in certain cases, rates for deducting income-tax from income chargeable under the head "salaries" and the rates for computing advance tax for the financial year 2009-10 i.e. A.Y.2010-11. Part III of the First Schedule to the Finance (No.2) Act, 2009 will become Part I of the First Schedule to the Finance Act, 2010 and so on.

(1) Individual / Hindu Undivided Family (HUF) / Association of Persons (AOP) / Body of Individuals (BOI) / Artificial Juridical Person.

(i) where the total income does not exceed Rs.1,60,000	*Nil;*
(ii) where the total income exceeds Rs.1,60,000 but does not exceed Rs.3,00,000	*10% of the amount by which the total income exceeds Rs.1,60,000*
(iii) where the total income exceeds Rs.3,00,000 but does not exceed Rs.5,00,000	*Rs.14,000 plus 20% of the amount by which the total income exceeds Rs.3,00,000;*
(iv) where the total income exceeds Rs.5,00,000	*Rs.54,000 plus 30% of the amount by which the total income exceeds Rs.5,00,000.*

***Illustration**: Mr. X has a total income of Rs.8,00,000. Compute his gross tax liability.*

Tax liability = Rs.54,000 + 30% of Rs.3,00,000 = Rs.1,44,000

Alternatively:

Tax liability :

First Rs.1,60,000	*- Nil*
Next Rs.1,60,000 – Rs.3,00,000	*- @ 10% of Rs.1,40,000 = Rs. 14,000*
Next Rs.3,00,000 – Rs.5,00,000	*- @ 20% of Rs.2,00,000 = Rs. 40,000*
Balance i.e. Rs.5,00,000–Rs.8,00,000	*- @ 30% of Rs.3,00,000 = Rs. 90,000*
	Total tax = Rs.1,44,000

1.4 Income Tax

It is to be noted that for a woman resident below the age of 65 years at any time during the previous year, the basic exemption limit is Rs.1,90,000 and for a senior citizen (being a resident individual who is of the age of 65 years or more at any time during the previous year), the basic exemption limit is Rs.2,40,000. Therefore, the tax slabs for these assessees would be as follows –

For resident women below the age of 65 years

(i) where the total income does not exceed Rs.1,90,000	*Nil;*
(ii) where the total income exceeds Rs.1,90,000 but does not exceed Rs.3,00,000	*10% of the amount by which the total income exceeds Rs.1,90,000*
(iii) where the total income exceeds Rs.3,00,000 but does not exceed Rs.5,00,000	*Rs.11,000 plus 20% of the amount by which the total income exceeds Rs.3,00,000;*
(iv) where the total income exceeds which Rs.5,00,000	*Rs.51,000 plus 30% of the amount by the total income exceeds Rs.5,00,000.*

For senior citizens (being resident individuals of the age of 65 years or more)

(i) where the total income does not exceed Rs.2,40,000	*Nil;*
(ii) where the total income exceeds Rs.2,40,000 but does not exceed Rs.3,00,000	*10% of the amount by which the total income exceeds Rs.2,40,000;*
(iii) where the total income exceeds Rs.3,00,000 but does not exceed Rs.5,00,000	*Rs.6,000 plus 20% of the amount by which the total income exceeds Rs.3,00,000;*
(iv) where the total income exceeds which Rs.5,00,000	*Rs.46,000 plus 30% of the amount by the total income exceeds Rs.5,00,000.*

(2) Firm/LLP

On the whole of the total income	30%

(3) Local authority

On the whole of the total income	30%

(4) Co-operative Society

(i) where the total income does not exceed Rs.10,000	10% of the total income;

(ii)	where the total income exceeds Rs.10,000 but does not exceed Rs.20,000	Rs.1,000 plus 20% of the amount by which the total income exceeds Rs.10,000
(iii)	where the total income exceeds Rs.20,000	Rs.3,000 plus 30% of the amount by which the total income exceeds Rs.20,000.
(5)	**Company**	
(a)	In the case of a domestic company	30% of the total income
(b)	In the case of a company other than a domestic company	50% of specified royalties & fees for a rendering technical services and 40% on the balance of total income.

The above rates are prescribed by the annual Finance Acts. However, in respect of certain types of income, as mentioned below, the Income-tax Act has prescribed specific rates –

(1) Section 112 has prescribed the rate of tax @20% in respect of long term capital gains (For details, refer Chapter 7 – Capital gains)

(2) Section 111A provides for a concessional rate of tax (i.e. 15%) on the short-term capital gains on transfer of -

(i) an equity share in a company or

(ii) a unit of an equity oriented fund.

The conditions for availing the benefit of this concessional rate are –

(i) the transaction of sale of such equity share or unit should be entered into on or after 1.10.2004 and

(ii) such transaction should be chargeable to securities transaction tax.

(3) Section 115BB prescribes the rate of tax @30% for winnings from-

(i) any lottery; or

(ii) crossword puzzle; or

(iii) race including horse race; or

(iv) card game and other game of any sort; or

(v) gambling or betting of any form.

1.6 Income Tax

SURCHARGE

(1) In the case of domestic companies, the rate of surcharge is 10%, where the total income exceeds Rs.1 crore.

(2) In the case of foreign companies, the rate of surcharge is 2.5%, where the total income exceeds Rs.1 crore.

(3) No surcharge is leviable for assessees, other than companies.

MARGINAL RELIEF

This concept of marginal relief is applicable only in the case of companies w.e.f. A.Y.2010-11. Marginal relief is available in case of companies having a total income exceeding Rs.1 crore i.e. the additional amount of income-tax payable (together with surcharge) on the excess of income over Rs.1 crore should not be more than the amount of income exceeding Rs.1 crore.

EDUCATION CESS AND SECONDARY AND HIGHER EDUCATION CESS ON INCOME-TAX

The amount of income-tax as increased by the union surcharge, if applicable, should be further increased by an additional surcharge called the "Education cess on income-tax", calculated at the rate of 2% of such income-tax and surcharge, if applicable. Education cess is leviable in the case of all assessees i.e. individuals, HUF, AOP / BOI, firms, local authorities, co-operative societies and companies. Further, "Secondary and higher education cess on income-tax" @1% of income-tax plus surcharge, if applicable, is leviable to fulfill the commitment of the Government to provide and finance secondary and higher education.

1.4 CONCEPT OF INCOME

The definition of income as per the Income-tax Act begins with the words "Income includes". Therefore, it is an inclusive definition and not an exhaustive one. Such a definition does not confine the scope of income but leaves room for more inclusions within the ambit of the term. Certain important principles relating to income are enumerated below -

- Income, in general, means a periodic monetary return which accrues or is expected to accrue regularly from definite sources. However, under the Income-tax Act, even certain income which do not arise regularly are treated as income for tax purposes e.g. Winnings from lotteries, crossword puzzles.
- Income normally refers to revenue receipts. Capital receipts are generally not included within the scope of income. However, the Income-tax Act has specifically included certain capital receipts within the definition of income e.g. Capital gains i.e. gains on sale of a capital asset like land.

- Income means net receipts and not gross receipts. Net receipts are arrived at after deducting the expenditure incurred in connection with earning such receipts. The expenditure which can be deducted while computing income under each head [For knowing about heads of income, see step 2 of para 1.6 below] is prescribed under the Income-tax Act.
- Income is taxable either on due basis or receipt basis. For computing income under the heads "Profits and gains of business or profession" and "Income from other sources", the method of accounting regularly employed by the assessee should be considered, which can be either cash system or mercantile system.
- Income earned in a previous year is chargeable to tax in the assessment year. Previous year is the financial year, ending on 31st March, in which income has accrued/ received. Assessment year is the financial year (ending on 31st March) following the previous year. The income of the previous year is assessed during the assessment year following the previous year. For instance, income of previous year 2009-10 is assessed during 2010-11. Therefore, 2010-11 is the assessment year for assessment of income of the previous year 2009-10.

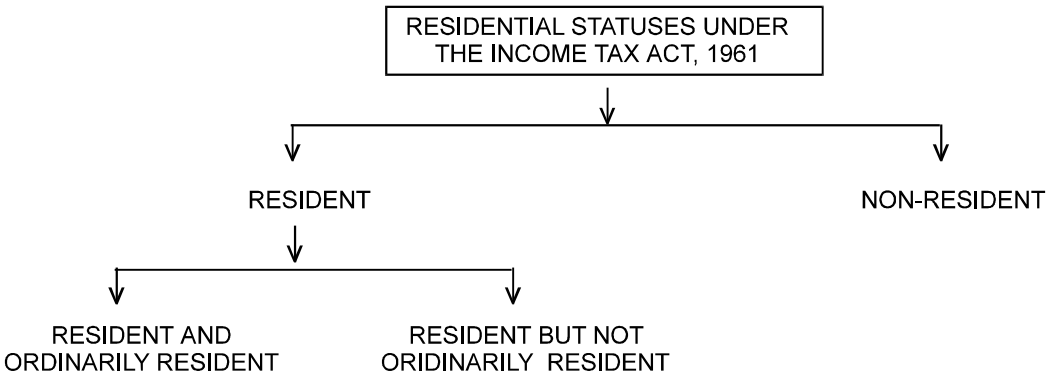
1.5 TOTAL INCOME AND TAX PAYABLE

Income-tax is levied on an assessee's total income. Such total income has to be computed as per the provisions contained in the Income-tax Act, 1961. Let us go step by step to understand the procedure of computation of total income for the purpose of levy of income-tax –

Step 1 – Determination of residential status

The residential status of a person has to be determined to ascertain which income is to be included in computing the total income.

The residential statuses as per the Income-tax Act are shown below –



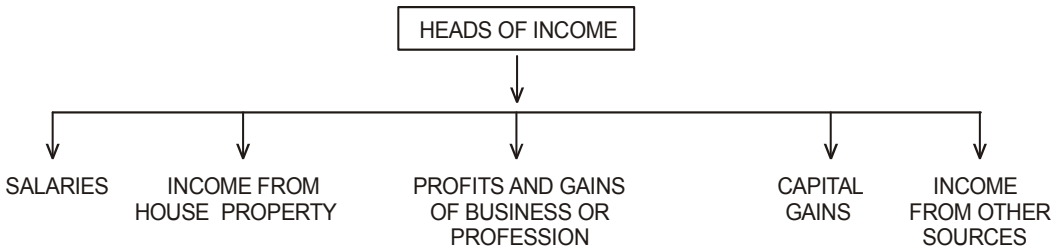
1.8 Income Tax

In the case of an individual, the duration for which he is present in India determines his residential status. Based on the time spent by him, he may be (a) resident and ordinarily resident, (b) resident but not ordinarily resident, or (c) non-resident.

The residential status of a person determines the taxability of the income. For e.g., income earned outside India will not be taxable in the hands of a non-resident but will be taxable in case of a resident and ordinarily resident.

Step 2 – Classification of income under different heads

The Act prescribes five heads of income. These are shown below –



These heads of income exhaust all possible types of income that can accrue to or be received by the tax payer. Salary, pension earned is taxable under the head "Salaries". Rental income is taxable under the head "Income from house property". Income derived from carrying on any business or profession is taxable under the head "Profits and gains from business or profession". Profit from sale of a capital asset (like land) is taxable under the head "Capital Gains". The fifth head of income is the residuary head under which income taxable under the Act, but not falling under the first four heads, will be taxed. The tax payer has to classify the income earned under the relevant head of income.

Step 3 - Exclusion of income not chargeable to tax

There are certain income which are wholly exempt from income-tax e.g. Agricultural income. These income have to be excluded and will not form part of Gross Total Income. Also, some incomes are partially exempt from income-tax e.g. House Rent Allowance, Education Allowance. These incomes are excluded only to the extent of the limits specified in the Act. The balance income over and above the prescribed exemption limits would enter computation of total income and have to be classified under the relevant head of income.

Step 4 - Computation of income under each head

Income is to be computed in accordance with the provisions governing a particular head of income. Under each head of income, there is a charging section which defines the scope of income chargeable under that head. There are deductions and allowances prescribed under each head of income. For example, while calculating income from house property, municipal taxes and interest on loan are allowed as deduction. Similarly, deductions and allowances are prescribed under other heads of income. These deductions etc. have to be considered before arriving at the net income chargeable under each head.

Step 5 – Clubbing of income of spouse, minor child etc.

In case of individuals, income-tax is levied on a slab system on the total income. The tax system is progressive i.e. as the income increases, the applicable rate of tax increases. Some taxpayers in the higher income bracket have a tendency to divert some portion of their income to their spouse, minor child etc. to minimize their tax burden. In order to prevent such tax avoidance, clubbing provisions have been incorporated in the Act, under which income arising to certain persons (like spouse, minor child etc.) have to be included in the income of the person who has diverted his income for the purpose of computing tax liability.

Step 6 – Set-off or carry forward and set-off of losses

An assessee may have different sources of income under the same head of income. He might have profit from one source and loss from the other. For instance, an assessee may have profit from his textile business and loss from his printing business. This loss can be set-off against the profits of textile business to arrive at the net income chargeable under the head “Profits and gains of business or profession”.

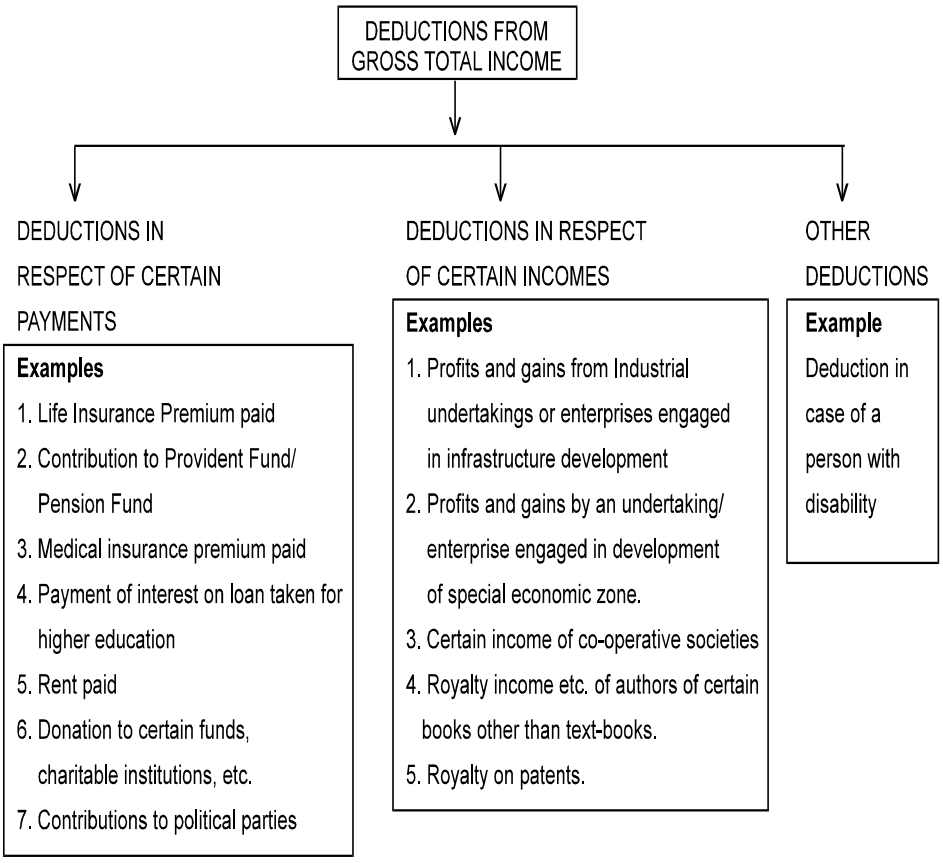
Similarly, an assessee can have loss under one head of income, say, Income from house property and profits under another head of income, say, Profits and gains of business or profession. There are provisions in the Income-tax Act for allowing inter-head adjustment in certain cases. Further, losses which cannot be set-off in the current year due to inadequacy of eligible profits can be carried forward for set-off in the subsequent years as per the provisions contained in the Act.

Step 7 – Computation of Gross Total Income.

The final figures of income or loss under each head of income, after allowing the deductions, allowances and other adjustments, are then aggregated, after giving effect to the provisions for clubbing of income and set-off and carry forward of losses, to arrive at the gross total income.

Step 8 – Deductions from Gross Total Income

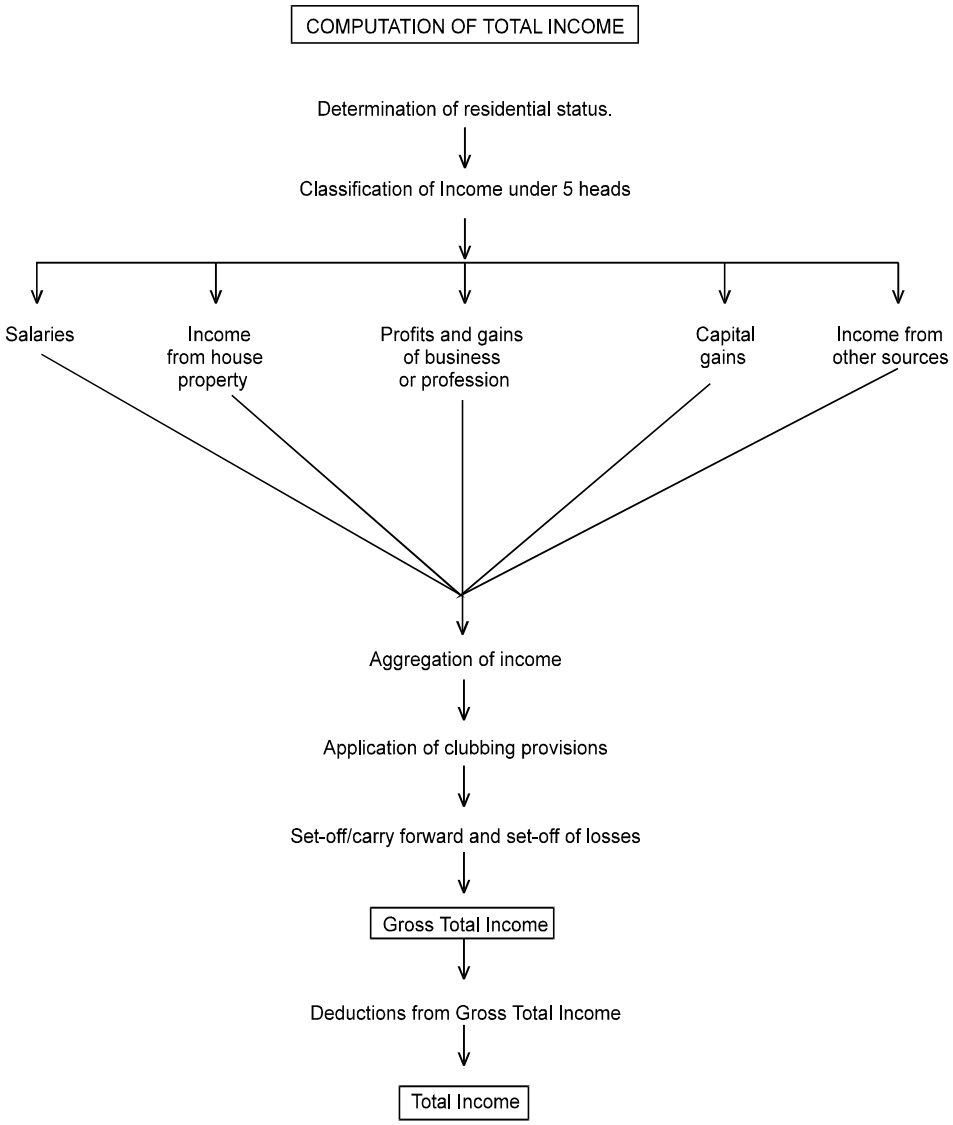
There are deductions prescribed from Gross Total Income. These deductions are of three types –



Step 9 – Total income

The income arrived at, after claiming the above deductions from the Gross Total Income is known as the Total Income. It is also called the Taxable Income. It should be rounded off to the nearest multiple of Rs.10.

The process of computation of total income is shown hereunder –



Step 10 – Application of the rates of tax on the total income

The rates of tax for the different classes of assesses are prescribed by the Annual Finance Act.

For individuals, HUFs etc., there is a slab rate and basic exemption limit. At present, the basic exemption limit is *Rs.1,60,000* for individuals. This means that no tax is payable by individuals with total income of up to *Rs.1,60,000*. Those individuals whose total income is more than *Rs.1,60,000* but less than *Rs.3,00,000* have to pay tax on their total income in excess of *Rs.1,60,000* @ 10% and so on. The highest rate is 30%, which is attracted in

respect of income in excess of *Rs.5,00,000*.

For firms and companies, a flat rate of tax is prescribed. At present, the rate is 30% on the whole of their total income.

The tax rates have to be applied on the total income to arrive at the income-tax liability.

Step 11 – Surcharge

Surcharge is an additional tax payable over and above the income-tax. Surcharge is levied as a percentage of income-tax. *From A.Y.2010-11 onwards, surcharge would be applicable only in the case of companies.* The rate of surcharge for domestic companies is 10% and for foreign companies is 2.5%, if their total income exceeds Rs.1 crore.

Step 12 – Education cess and secondary and higher education cess on income-tax

The income-tax, as increased by the surcharge, if applicable, is to be further increased by an additional surcharge called education cess@2%. The Education cess on income-tax is for the purpose of providing universalised quality basic education. This is payable by all assesses who are liable to pay income-tax irrespective of their level of total income. Further, "secondary and higher education cess on income-tax" @1% of income-tax plus surcharge, if applicable, is leviable from A.Y.2008-09 to fulfill the commitment of the Government to provide and finance secondary and higher education.

Step 13 - Advance tax and tax deducted at source

Although the tax liability of an assessee is determined only at the end of the year, tax is required to be paid in advance in certain installments on the basis of estimated income. In certain cases, tax is required to be deducted at source from the income by the payer at the rates prescribed in the Act. Such deduction should be made either at the time of accrual or at the time of payment, as prescribed by the Act. For example, in the case of salary income, the obligation of the employer to deduct tax at source arises only at the time of payment of salary to the employees. Such tax deducted at source has to be remitted to the credit of the Central Government through any branch of the RBI, SBI or any authorized bank. If any tax is still due on the basis of return of income, after adjusting advance tax and tax deducted at source, the assessee has to pay such tax (called self-assessment tax) at the time of filing of the return.

1.6 IMPORTANT DEFINITIONS

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

certain terms like "dividend", "transfer", etc. have been given a wider meaning in the Income-tax Act than they are commonly understood.

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

(1) ASSESSEE [Section 2(7)] - Assessee means a person by whom any tax or any other sum of money is payable under this Act. It includes every person in respect of whom any proceeding has been taken for the assessment of his income or assessment of fringe benefits. Sometimes, a person becomes assessable in respect of the income of some other persons. In such a case also, he may be considered as an assessee. This term also includes every person who is deemed to be an assessee or an assessee in default under any provision of this Act.

(2) ASSESSMENT [Section 2(9)] - This is the procedure by which the income of an assessee is determined by the Assessing Officer. It may be by way of a normal assessment or by way of reassessment of an income previously assessed.

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

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

(i) an individual,

(ii) a Hindu Undivided Family (HUF),

(iii) a company,

(iv) a firm,

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

(vi) a local authority, and

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

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

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

(ii) HUF - Under the Income-tax Act, a Hindu undivided family (HUF) is treated as a separate entity for the purpose of assessment. It is included in the definition of the term "person" under section 2(31). The levy of income-tax is on "every person". Therefore,

income-tax is payable by a HUF. "Hindu undivided family" has not been defined under the Income-tax Act. The expression is however defined under the Hindu Law as a family, which consists of all males lineally descended from a common ancestor and includes their wives and unmarried daughters.

The relation of a HUF does not arise from a contract but arises from status. A Hindu is born into a HUF. A male member continues to remain a member of the family until there is a partition of the family. After the partition, he ceases to be a member of one family. However, he becomes a member of another smaller family. A female member ceases to be a member of the HUF in which she was born, when she gets married. Thereafter, she becomes a member of the HUF of her husband.

Some members of the HUF are called co-parceners. They are related to each other and to the head of the family. HUF may contain many members, but members within four degrees including the head of the family (kartha) are called co-parceners. A hindu co-parcenary includes those persons who acquire by birth an interest in the joint coparcenary property. Only the coparceners have a right to partition.

A Jain undivided family would also be assessed as a HUF, as Jains are also governed by the laws as Hindus.

Schools of Hindu Law

There are two schools of hindu law. They are –

(1) Mithakshara school of hindu law

(2) Dayabhaga school of hindu law

Mithakshara law is followed by entire India except West Bengal and Assam. There is a basic difference between the two schools of thought with regard to succession. Under the Mithakshara law, the inheritance is by birth. One acquires the right to the family property by his birth and not by succession irrespective of the fact that his elders are living. Thus every child born in the family acquires a right/share in the family property.

Dayabagha law prevails in West Bengal and Assam. In Dayabagha law, nobody acquires the right, share in the property by birth as long as the head of family is living, that is, the children do not acquire any right, share in the family property, as long as his father is alive and only on death of the father, the children will acquire right/share in the property. Thus, the father and his brothers would be the coparceners of the HUF

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

(1) any Indian company as defined in section 2(26); or

(2) any body corporate incorporated by or under the laws of a country outside India, i.e.,

any foreign company; or

(3) any institution, association or body which is assessable or was assessed as a company for any assessment year under the Indian Income-tax Act, 1922 or for any assessment year commencing on or before 1.4.1970 under the present Act; or

(4) any institution, association or body, whether incorporated or not and whether Indian or non-Indian, which is declared by a general or special order of the CBDT to be a company for such assessment years as may be specified in the CBDT's order.

Classes of Companies

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

Indian company [Section 2(26)] - Two conditions should be satisfied so that a company can be regarded as an Indian company -

(a) the company should have been formed and registered under any law relating to companies which was or is in force in any part of India, and

(b) the registered office or the principal office of the company should be in India.

The expression 'Indian Company' also includes:

(i) A corporation established by or under a Central, State or Provincial Act (like Financial Corporation or a State Road Transport Corporation),

(ii) An institution or association or body which is declared by the Board to be a company under section 2(17)(iv) provided its registered or principal office is in India.

(iii) in the case of the State of Jammu and Kashmir, a company formed and registered under any law for the time being in force in that State.

(iv) in the case of any of the Union territories of Dadra and Nagar Haveli, Goa, Daman and Diu, and Pondicherry, a company formed and registered under any law for the time being in force in that Union territory.

Company in which public are substantially interested [Section 2(18)] - The following companies are said to be companies in which the public are substantially interested:

(i) A company owned by the Government (either Central or State but not Foreign) or the Reserve Bank of India (RBI) or in which not less than 40% of the shares are held by the Government or the RBI or corporation owned by that bank.

(ii) A company which is registered under section 25 of the Companies Act, 1956 (formed for promoting commerce, arts, science, religion, charity or any other useful object).

(iii) A company having no share capital which is declared by the Board for the specified

assessment years to be a company in which the public are substantially interested.

(iv) A company which is not a private company as defined in the Companies Act, 1956 and which fulfills any of the following conditions :

- its equity shares should have, as on the last day of the relevant previous year, been listed in a recognised stock exchange in India; or
- its equity shares carrying at least 50% (40% in case of industrial companies) voting power should have been unconditionally allotted to or acquired by and should have been beneficially held throughout the relevant previous year by (a) Government or (b) a Statutory Corporation or (c) a company in which public are substantially interested or (d) any wholly owned subsidiary of company mentioned in (c).

(v) A company which carries on its principal business of accepting deposits from its members and which is declared by the Central Government under section 620A of the Companies Act to be Nidhi or a Mutual Benefit Society.

(vi) A company whose equity shares carrying at least 50% of the voting power have been allotted unconditionally to or acquired unconditionally by and were beneficially held throughout the relevant previous year by one or more co-operative societies.

Person having substantial interest in the company [Section 2(32)] – is a person who is the beneficial owner of shares (not being shares entitled to a fixed rate of dividend), whether with or without a right to participate in profits, carrying at least 20% of the total voting power.

Note: The main criterion is the 'beneficial' ownership and not 'legal' ownership. Therefore, the registered holder of even the majority of equity shares, would not fall within this definition if he has no beneficial interest in the shares. On the other hand, a person who is beneficially entitled to atleast 20% of the equity share capital of a company would fall within this definition even if he is not the registered holder of any shares.

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

(iv) Firm - The terms 'firm', 'partner' and 'partnership' have the same meanings as assigned to them in the Indian Partnership Act. *In addition, the definitions also include the terms as they have been defined in the Limited Liability Partnership Act, 2008.* However, for income-tax purposes a minor admitted to the benefits of an existing partnership would also be treated as partner. This is specified under section 2(23) of the Act. A partnership is the relation between persons who have agreed to share the profits of business carried on by all or any of them acting for all. The persons who have entered into partnership with one another are called individually 'partners' and collectively a 'firm'.

Note –

(i) Consequent to the Limited Liability Partnership Act, 2008 coming into effect in 2009 and notification of the Limited Liability Partnership Rules w.e.f. 1st April, 2009, the Finance (No.2) Act, 2009 has incorporated the taxation scheme of LLPs in the Income-tax Act on the same lines as applicable for general partnerships, i.e. tax liability would be attracted in the hands of the LLP and tax exemption would be available to the partners. Therefore, the same tax treatment would be applicable for both general partnerships and LLPs.

(ii) Consequently, the following definitions in section 2(23) have been amended -

(1) The definition of 'partner' to include within its meaning, a partner of a limited liability partnership;

(2) The definition of 'firm' to include within its meaning, a limited liability partnership; and

(3) The definition of 'partnership' to include within its meaning, a limited liability partnership.

The definition of these terms under the Income-tax Act would, in effect, also include the terms as they have been defined in the Limited Liability Partnership Act, 2008. Section 2(q) of the LLP Act, 2008 defines a 'partner' as any person who becomes a partner in the LLP in accordance with the LLP agreement. An LLP agreement has been defined under section 2(o) to mean any written agreement between the partners of the LLP or between the LLP and its partners which determines the mutual rights and duties of the partners and their rights and duties in relation to the LLP.

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

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

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

1.18 Income Tax

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

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

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

(1) Profits and gains.

(2) Dividends.

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

Scientific research association approved under section 35(1)(ii)	10(21)
Universities and other educational institutions	10(23C)(iiiad) and (vi)
Hospitals and other medical institutions	10(23C) (iiiae) and (via)
Notified funds or institutions established for charitable purposes	10(23C)(iv)
Notified trusts or institutions established wholly for public religious purposes or wholly for public religious and charitable purposes	10(23C)(v)
Electoral trust	*13B*

(4) The value of any perquisite or profit in lieu of salary taxable under section 17.

(5) Any special allowance or benefit other than the perquisite included above, specifically granted to the assessee to meet expenses wholly, necessarily and exclusively for the performance of the duties of an office or employment of profit.

(6) Any allowance granted to the assessee to meet his personal expenses at the place where the duties of his office or employment of profit are ordinarily performed by him or at a place where he ordinarily resides or to compensate him for the increased cost of living.

(7) 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.

(8) The value of any benefit or perquisite, whether convertible into money or not, which is obtained by any representative assessee mentioned under section 160(1)(iii) and (iv), or by any beneficiary or any amount paid by the representative assessee for the benefit of the beneficiary which the beneficiary would have ordinarily been required to pay.

(9) Deemed profits chargeable to tax under section 41 or section 59.

(10) Profits and gains of business or profession chargeable to tax under section 28.

(11) Any capital gains chargeable under section 45.

(12) The profits and gains of any insurance business carried on by Mutual Insurance Company or by a cooperative society, computed in accordance with Section 44 or any surplus taken to be such profits and gains by virtue of the provisions contained in the first Schedule to the Act.

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

(14) Any winnings from lotteries, cross-word puzzles, races including horse races, card games and other games of any sort or from gambling, or betting of any form or nature whatsoever. For this purpose,

(i) "Lottery" includes winnings, from prizes awarded to any person by draw of lots or by chance or in any other manner whatsoever, under any scheme or arrangement by whatever name called;

(ii) "Card game and other game of any sort" includes any game show, an entertainment programme on television or electronic mode, in which people compete to win prizes or any other similar game.

(15) Any sum received by the assessee from his employees as contributions to any provident fund (PF) or superannuation fund or Employees State Insurance Fund (ESI) or any other fund for the welfare of such employees.

(16) Any sum received under a Keyman insurance policy including the sum allocated by way of bonus on such policy will constitute income.

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

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

(18) Any sum referred to in section 56(2)(vi) – Gifts received by an individual or HUF from non-relatives on or after 1.4.2006 *but before 1.10.2009*, if the aggregate value of such gifts exceed Rs.50,000 during a year.

(19) Any sum of money or value of property referred to in section 56(2)(vii) w.e.f. 1.10.2009

Students should carefully study the various items of receipts included in the above definition. Some of them like capital gains are not revenue receipts. However, since they have been included in the definition, they are chargeable as income under the Act. The concept of revenue and capital receipts is discussed hereunder –

The Act contemplates a levy of tax on income and not on capital and hence it is very essential to distinguish between capital and revenue receipts. The distinction between capital and revenue receipts is somewhat blurred. Even then, capital receipts cannot be taxed, unless they fall within the scope of the definition of "income" and so the distinction remains real and most material for tax purposes.

Certain capital receipts which have been specifically included in the definition of income are Compensation for modification or termination of services, income by way of capital gains etc.

It is not possible to lay down any single test as infallible or any single criterion as decisive, final and universal in application to determine whether a particular receipt is capital or revenue in nature. Hence, the capital or revenue nature of the receipt must be determined with reference to the facts and circumstances of each case.

Distinction between capital and revenue receipts

The following are some of the important criteria which may be applied to distinguish between capital and revenue receipts.

(1) A receipt referable to fixed capital would be a capital receipt whereas a receipt referable to circulating capital would be a revenue receipt. The former is exempt from tax while the latter is taxable. In cases where a capital asset is transmuted into income and the price realized on its sale takes the form of periodic payments (e.g., annuities and annual installment of capital), the receipt would be taxable even though it is referable to a capital asset.

(2) Profits arising from the sale of a capital asset are chargeable to tax as capital gains under section 45 whereas profits arising from the sale of a trading asset being of revenue nature are taxable as income from business under section 28 provided that the sale is in the regular course of assessees' business or the transaction constitutes an adventure in the nature of trade.

(3) Profits arising from transactions which are entered into in the course of the business regularly carried on by the assessee, or are incidental to, or associated with the business of the assessee would be revenue receipts chargeable to tax. For example, a banker's or financier's dealings in foreign exchange or sale of shares and securities, a shipbroker's purchases of ship in his own name, a share broker's purchase of shares on his own account would constitute transactions entered and yielding income in the ordinary course of their business. If transactions are partly in the course of and partly outside the regular trading activity of the assessee, the income arising therefrom must be segregated and allocated between the two parts and treated accordingly for tax purposes.

(4) In the case of profit arising from the sale of shares and securities the nature of the profit has to be ascertained from the motive, intention or purpose with which they were bought. If the shares were acquired as an investor or with a view to acquiring a controlling interest or for obtaining a managing or selling agency or a directorship the profit or loss on their sale would be of a capital nature; but if the shares were acquired in the ordinary course of business as a dealer in shares, it would be a taxable receipt. If the shares were acquired with speculative motive the profit or loss (although of a revenue nature) would have to be dealt with separately from other business.

(5) Even a single transaction may constitute a business or an adventure in the nature of trade even if it is outside the normal course of the assessee's business. Repetition of such transactions is not necessary. Thus, a bulk purchase followed by a bulk sale or a series of retail sales or bulk sale followed by a series of retail purchases would constitute an adventure in the nature of trade and consequently the income arising therefrom would be taxable. Purchase of any article with no intention to resell it, but resold under changed circumstances would be a transaction of a capital nature and capital gains arise. However, where an asset is purchased with the intention to resell it, the question whether the profit on sale is capital or revenue in nature depends upon (i) the conduct of the assessee, (ii) the nature and quantity of the article purchased, (iii) the nature of the operations involved, (iv) whether the venture is on capital or revenue account, and (v) other related circumstances of the case.

(6) In the case of annuities which are payable in specified sums at periodic intervals of time the receipt would be of a revenue nature even though it involves the conversion of capital into income for an annuity means the purchase of an income. An annuity received from an employer is taxable as "Income from salaries" whereas all other annuities are chargeable under the head "Income from other sources".

1.22 Income Tax

Annual payments, as distinguished from annuities, are in fact annual installments of capital. The purchase price of a business or property may be agreed to be paid in installments annually or otherwise. In such cases, the amount of installment received would be of capital nature not liable to tax. Thus, on the sale of property or business in consideration of annual payment:

(i) if the sale is for a price which is to be paid in installments, the installments would be capital receipts;

(ii) if the property is sold for an annuity payable regularly, the property disappears and the annuity which takes its place would be chargeable to tax;

(iii) if the property is sold for what looks like an annuity but actually there is no transmutation of the principal sum into income and the annual payments are merely installments of the principal sum with interest only so much of the amount of installments as representing the interest payable would be income chargeable to tax, the balance being capital receipt; and

(iv) if the property is sold for a consideration which is share of the profits or gross receipt of a business, the receipt of the share of profits would be the sale price but still chargeable to tax as income provided that the true bargain was to secure an income and not a fixed capital sum. However, if the circumstances of the case show that the receipts were only installments of a capital nature, though fluctuating in amount and measurable with reference to profits, they would not be taxable.

(7) A receipt in substitution of a source of income is capital receipt not chargeable to tax. Thus compensation received for restraint of trade or profession is a capital receipt. Where an assessee receives compensation of termination of the agency business being the only source of income the receipt is a capital nature but taxable under section 28(ii). But where the assessee has a number of agencies and one of them is terminated and compensation received therefore, the receipt would be of a revenue nature since taking agencies and exploiting the same for earning income is the ordinary course of business and the loss of one agency would be made good by taking another. Compensation received from the employer for premature termination of the service contract is a revenue receipt taxable under section 15. In case where the compensation received is partly of a capital and partly of a revenue nature, the two will have to be segregated and treated accordingly for tax purposes.

Awards in the case of a sportsman, who is not a professional, will not be liable to tax in his hands as it would not be in the nature of income.

A lump sum payment made gratuitously (i.e. gratuity, leave encashment) or by way of compensation or otherwise to the widow or other legal heirs of an employee, who dies while still in active service, is not taxable as income under the Act.

(8) A lumpsum paid in commutation of salaries, pension, royalties or other periodic payments would be income taxable under the respective heads. Amount received under a policy of insurance would be a capital or revenue receipt depending upon the fact whether the policy was held by the assessee as a capital asset or as a trading asset. Likewise, subsidies or grants received from the Government would be generally of a revenue nature since they would be to supplement the income from business. But where a grant is received for specific purpose but not as a supplementary trading receipt (*e.g.*, to enable the company to relieve unemployment or promote family planning) the receipt would be of a capital nature not chargeable to tax. Premium or discount received by a debenture holder, being a capital receipt, would not be chargeable to tax

Mining royalties are revenue receipts taxable as income from other sources irrespective of the fact whether they are received in lump sum or by way of a fixed annual sum or a tonnage royalty or the minimum royalty. Similarly, royalties paid for use of whether paid in lump sum or in installments of fixed or varying amounts would be taxable as income whereas the payment received in lieu of total or partial assignment of patent under which the owner ceases to own the patent as a capital asset would constitute a capital receipt.

Premium on issue of shares or debentures, profit on forfeiture of shares and the fee charged on fresh issue of shares are capital receipts not chargeable to tax. The amount received by a shareholder on the winding up is a capital receipt (except where the receipt is a dividend under section 2(22)). But in case of a partnership, the amount receivable by an outgoing partner in respect of his share of the firm's profit whether, before or after its dissolution would be a revenue receipt chargeable to tax. Compensation received by a partner for relinquishing all his interests in the firm and amounts received in settlement of claim to an interest in the capital of a firm are capital receipts.

It is necessary to note that the capital or revenue nature of a receipt would have to be determined on the basis of the particular facts and circumstances of each case and the question whether a certain item is capital or revenue would be a mixed question of law and fact.

(9) Normally, gifts constitute capital receipts in the hands of the recipient. However, it is possible that gifts may partake the character of income under certain circumstances.

Example :

(i) Gifts received by doctors from their patients is taxable under the head Profits and Gains from Business or Profession.

(ii) *Any sum of money or value of property received without consideration or for inadequate consideration by an individual or a HUF from any person, other than a relative, is chargeable under the head "Income from Other Sources" [For details, refer to Chapter 8 on "Income from Other Sources"].*

1.24 Income Tax

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

(a) Distribution of accumulated profits, entailing the release of company's assets - Any distribution of accumulated profits, whether capitalised or not, by a company to its shareholders is dividend if it entails the release of all or any part of its assets. For example, if accumulated profits are distributed in cash it is dividend in the hands of the shareholders. Where accumulated profits are distributed in kind, for example by delivery of shares etc. entailing the release of company's assets, the market value of such shares on the date of such distribution is deemed dividend in the hands of the shareholder.

(b) Distribution of debentures, deposit certificates and bonus shares to preference shareholders - Any distribution to its shareholders by a company of debenture stock or deposit certificate in any form, whether with or without interest, and any distribution of bonus shares to preference shareholders to the extent to which the company possesses accumulated profits, whether capitalised or not, will be deemed as dividend. The market value of such bonus shares is taxable in the hands of the preference shareholder. In the case of debentures, debenture stock etc., their value is to be taken at the market rate and if there is no market rate they should be valued according to accepted principles of valuation.

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

(c) Distribution on liquidation - Any distribution made to the shareholders of a company on its liquidation, to the extent to which the distribution is attributable to the accumulated profits of the company immediately before its liquidation, whether capitalised or not, is deemed to be dividend income.

Note: Any distribution made out of the profits of the company after the date of the liquidation cannot amount to dividend. It is a repayment towards capital.

Accumulated profits include all profits of the company up to the date of liquidation whether capitalised or not. But where liquidation is consequent to the compulsory acquisition of an undertaking by the Government or by any corporation owned or controlled by the Government, the accumulated profits do not include any profits of the company prior to the 3 successive previous years immediately preceding the previous year in which such acquisition took place subject to certain exceptions.

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

Exception - The same exceptions as given in case (c) above shall also apply in this case.

(e) Advance or loan by a closely held company to its shareholder - Any payment by a company in which the public are not substantially interested of any sum by way of

advance or loan to any shareholder who is the beneficial owner of 10% or more of the equity capital of the company will be deemed to be dividend to the extent of the accumulated profits. If the loan is not covered by the accumulated profits, it is not deemed to be dividend.

There are two exceptions to this rule:

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

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

Advance or loan by a closely held company to a specified concern - Any payment by a company in which the public are not substantially interested to any concern (i.e. HUF / Firm / AOP / BOI / Company) in which a shareholder, having the beneficial ownership of atleast 10% of the equity shares is a member or a partner and in which he has a substantial interest (i.e. atleast 20% share of the income of the concern). The dividend income shall be taxable in the hands of the concern. Also, any payments by such a closely held company on behalf of, or for the individual benefit of any such shareholder will also deemed to be dividend. However, in both cases the ceiling limit of dividend is the extent of accumulated profits.

Illustration : Suppose Mr. X is a shareholder in a Company A as well as Company B. He has 10% shareholding in Company A and 20% shareholding in Company B. The accumulated profits of Company A = Rs.10 lakh. A loan of Rs.12 lakh is given by Company A to Company B. This loan up to the extent of accumulated profits of Rs.10 lakh is treated as dividend and is taxable in the hands of Company B.

Other exceptions

Apart from the exceptions cited above, the following also do not constitute "dividend" -

(i) Any payment made by a company on purchase of its own shares from a shareholder in accordance with the provisions of section 77A of the Companies Act, 1956;

(ii) any distribution of shares on demerger by the resulting companies to the shareholders of the demerged company (whether or not there is a reduction of capital in the demerged company).

Basis of charge of dividend

Any income by way of dividends, referred to under section 115-O, is excluded from the total income of the shareholder [Section 10(34)]. Under section 115-O, any dividend

declared, distributed or paid by a domestic company, whether out of current or accumulated profits, shall be charged to additional income-tax at a flat rate of *15%* in addition to normal income-tax chargeable on the income of the company. This is known as corporate dividend tax. Corporate dividend tax is not leviable on deemed dividend under section 2(22)(e). Hence, the same will be taxed in the hands of the shareholder.

Dividends received from a company, other than a domestic company, are still liable to tax in the hands of the shareholder. For example, dividend received from a foreign company is liable to tax in the hands of the shareholder.

Year of accrual of dividend

Section 8 of the Act provides that deemed dividend under section 2(22) declared by a company or distributed or paid by it shall be deemed to be the income of the previous year in which it is declared, distributed or paid, as the case may be. Any interim dividend shall be deemed to be the income of the previous year in which the amount is unconditionally made available to the member who is entitled to it.

(6) INDIA [Section 2(25A)] – The term 'India' means –

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

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

(iii) continental shelf,

(iv) exclusive economic zone or

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

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

(7) INFRASTRUCTURE CAPITAL COMPANY [Section 2(26A)] – "Infrastructure capital company" means such company which makes investments by way of acquiring shares or providing long-term finance to -

(1) any enterprise or undertaking wholly engaged -

  (a) in the business referred to in section 80-IA(4) i.e. business of

    (i) developing/operating and maintaining/developing, operating and maintaining any infrastructure facility fulfilling the specified conditions

    (ii) providing telecom services, whether basic or cellular

    (iii) developing, developing and operating or maintaining and operating an industrial park or special economic zone notified by the Central Government

(iv) generating, transmitting or distributing power or undertaking substantial renovation and modernization of the existing network of transmission or distribution lines.

(b) in the business referred to in section 80-IAB(1) i.e. any business of developing a SEZ.

(2) an undertaking developing and building a housing project referred to in section 80-IB(10) i.e. approved before 31.3.2007 by a local authority and commences or commenced development and construction on or after 1.10.98 and completes or completed development and construction within the time specified.

(3) a project for constructing a hotel of not less than three-star category as classified by the Central Government or

(4) a project for constructing a hospital with at least 100 beds for patients.

(8) INFRASTRUCTURE CAPITAL FUND [Section 2(26B)] – Infrastructure capital fund means such fund operating under a trust deed registered under the provisions of the Registration Act, 1908 established to raise monies by the trustees for investment by way of acquiring shares or providing long-term finance to -

(1) any enterprise or undertaking wholly engaged in the business referred to in section 80-IA(4) or section 80-IAB(1) or

(2) an undertaking developing and building a housing project referred to in section 80-IB(10) or

(3) a project for constructing a hotel of not less than three star category as classified by the Central Government or

(4) a project for constructing a hospital with at least 100 beds for patients.

(9) MANUFACTURE [Section 2(29BA)] – *'Manufacture', with its grammatical variations, shall mean a change in a non-living physical object or article or thing,—*

(a) resulting in transformation of the object or article or thing into a new and distinct object or article or thing having a different name, character and use; or

(b) bringing into existence of a new and distinct object or article or thing with a different chemical composition or integral structure.

1.7 OTHER BASIC CONCEPTS

(1) Meaning of Assessment Year and Previous Year

(i) Assessment year - The term has been defined under section 2(9). This means a period of 12 months commencing on 1st April every year. The year in which tax is paid is called the assessment year while the year in respect of the income of which the tax is

levied is called the previous year. *For example, for the assessment year 2010-11, the relevant previous year is 2009-10 (1.4.2009 to 31.3.2010).*

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

Business or profession newly set up during the financial year - In such a case, the previous year shall be the period beginning on the date of setting up of the business or profession and ending with 31st March of the said financial year.

If a source of income comes into existence in the said financial year, then the previous year will commence from the date on which the source of income newly comes into existence and will end with 31st March of the financial year.

Illustration:

1. A is running a business from 1992 onwards. Determine the previous year for the *assessment year 2010-11*.

Ans. The previous year will be *1.4.2009 to 31.3.2010.*

2. A chartered accountant sets up his profession on *1st July, 2009*. Determine the previous year for the *assessment year 2010-11.*

Ans. The previous year will be from *1.7.2009 to 31.3.2010*.

(2) Previous Year for Undisclosed sources of income

There are many occasions when the Assessing Officer detects cash credits, unexplained investments, unexplained expenditure etc, the source for which is not satisfactorily explained by the assessee to the Assessing Officer. The Act contains a series of provisions to provide for these contingencies:

(i) Cash Credits [Section 68]

Where any sum is found credited in the books of the assessee and the assessee offers no explanation about the nature and source or the explanation offered is not satisfactory in the opinion of the Assessing Officer, the sum so credited may be charged as income of the assessee of that previous year.

(ii) Unexplained Investments [Section 69]

Where in the financial year immediately preceding the assessment year, the assessee has made investments which are not recorded in the books of account and the assessee offers no explanation about the nature and the source of investments or the explanation offered is not satisfactory, the value of the investments are taxed as income of the assessee of such financial year.

(iii) Unexplained money etc. [Section 69A]

Where in any financial year the assessee is found to be the owner of any money, bullion, jewellery or other valuable article and the same is not recorded in the books of account and the assessee offers no explanation about the nature and source of acquisition of such money, bullion etc. or the explanation offered is not satisfactory, the money and the value of bullion etc. may be deemed to be the income of the assessee for such financial year. Ownership is important and mere possession is not enough.

(iv) Amount of investments etc., not fully disclosed in the books of account [Section 69B]

Where in any financial year the assessee has made investments or is found to be the owner of any bullion, jewellery or other valuable article and the Assessing Officer finds that the amount spent on making such investments or in acquiring such articles exceeds the amount recorded in the books of account maintained by the assessee and he offers no explanation for the difference or the explanation offered is unsatisfactory, such excess may be deemed to be the income of the assessee for such financial year.

For example, if the assessee is found to be the owner of say 300 gms of gold (market value of which is Rs.25,000) during the financial year ending 31.3.10 but he has recorded to have spent Rs.15,000 in acquiring it, the Assessing Officer can add Rs.10,000 (i.e. the difference of the market value of such gold and Rs.15,000) as the income of the assessee, if the assessee offers no satisfactory explanation thereof.

(v) Unexplained expenditure [Section 69C]

Where in any financial year an assessee has incurred any expenditure and he offers no explanation about the source of such expenditure or the explanation is unsatisfactory the Assessing Officer can treat such unexplained expenditure as the income of the assessee for such financial year. Such unexplained expenditure which is deemed to be the income of the assessee shall not be allowed as deduction under any head of income.

(vi) Amount borrowed or repaid on hundi [Section 69D]

Where any amount is borrowed on a hundi or any amount due thereon is repaid other than through an account-payee cheque drawn on a bank, the amount so borrowed or repaid shall be deemed to be the income of the person borrowing or repaying for the previous year in which the amount was borrowed or repaid, as the case may be.

However, where any amount borrowed on a hundi has been deemed to be the income of any person, he will not be again liable to be assessed in respect of such amount on repayment of such amount. The amount repaid shall include interest paid on the amount borrowed.

(3) Certain cases when income of a previous year will be assessed in the previous year itself

The income of an assessee for a previous year is charged to income-tax in the assessment year following the previous year. However, in a few cases, this rule does not apply and the income is taxed in the previous year in which it is earned. These exceptions have been made to protect the interests of revenue. The exceptions are as follows:

(i) Shipping business of non-resident [Section 172] - Where a ship, belonging to or chartered by a non-resident, carries passengers, livestock, mail or goods shipped at a port in India, the ship is allowed to leave the port only when the tax has been paid or satisfactory arrangement has been made for payment thereof. 7.5% of the freight paid or payable to the owner or the charterer or to any person on his behalf, whether in India or outside India on account of such carriage is deemed to be his income which is charged to tax in the same year in which it is earned.

(ii) Persons leaving India [Section 174] - Where it appears to the Assessing Officer that any individual may leave India during the current assessment year or shortly after its expiry and he has no present intention of returning to India, the total income of such individual for the period from the expiry of the respective previous year up to the probable date of his departure from India is chargeable to tax in that assessment year.

Example: Suppose Mr. X is leaving India for USA on *10.6.2010* and it appears to the Assessing Officer that he has no intention to return. Before leaving India, Mr. X will be required to pay income tax on the income earned during the *P.Y. 2009-10* as well as the total income earned during the period *1.4.2010 to 10.06.2010.*

(iii) AOP / BOI / Artificial Juridical Person formed for a particular event or purpose [Section 174A] - If an AOP/BOI etc. is formed or established for a particular event or purpose and the Assessing Officer apprehends that the AOP/BOI is likely to be dissolved in the same year or in the next year, he can make assessment of the income up to the date of dissolution as income of the relevant assessment year.

(iv) Persons likely to transfer property to avoid tax [Section 175] - During the current assessment year, if it appears to the Assessing Officer that a person is likely to charge, sell, transfer, dispose of or otherwise part with any of his assets to avoid payment of any liability under this Act, the total income of such person for the period from the expiry of the previous year to the date, when the Assessing Officer commences proceedings under this section is chargeable to tax in that assessment year.

(v) Discontinued business [Section 176] - Where any business or profession is discontinued in any assessment year, the income of the period from the expiry of the previous year up to the date of such discontinuance may, at the discretion of the Assessing Officer, be charged to tax in that assessment year.

Self-examination questions

1. Define the following terms under the Income-tax Act, 1961 -
   (i) Assessee
   (ii) Person
   (iii) Previous year
2. Write short notes on the following -
   (i) Year of accrual of dividend
   (ii) Marginal relief
3. "Income of a previous year will be charged to tax in the assessment year following the previous year"- Discuss the exceptions to this general rule.
4. In certain cases, unexplained cash credit, unexplained investment, unexplained money or unexplained jewellery etc. is detected by the Assessing Officer. What is the previous year for charging such income to tax? Explain.
5. Define "Infrastructure capital company" and "Infrastructure capital fund".
6. Can expenditure incurred to earn dividend income (from both Indian companies and foreign companies) be claimed as deduction? Discuss.
7. What is the significance of heads of income under the Income-tax Act, 1961?
8. Rajdhani Ltd. deposited the share application money with its banker and earned interest thereon. The Assessing Officer sought to tax the interest earned on the deposit as income for the relevant assessment year, when the allotment process was not yet complete. The allotment process was completed only in the next assessment year. Is the Assessing Officer right in bringing to tax interest earned on such deposit in the current assessment year when the allotment process was not complete?
9. The Assessing Officer found, during the course of assessment of a firm, that it had paid rent in respect of its business premises amounting to Rs.60,000, which was not debited in the books of account for the year ending 31.3.2010. The firm did not explain the source for payment of rent. The Assessing Officer proposes to make an addition of Rs.60,000 in the hands of the firm for the assessment year 2010-11. The firm claims that even if the addition is made, the sum of Rs.60,000 should be allowed as deduction while computing its business income since it has been expended for purposes of its business. Examine the claim of the firm.
10. ABC Ltd. claimed that it had purchased water tanks from an one M/s. Rama Services, and made the entry in its books of account as a liability. The Assessing Officer found M/s. Rama Services was not assessed to tax and its books of account were reported

to have been lost. These two factors aroused suspicion in the mind of the Assessing Officer. On inquiry, the Assessing Officer found that such purchases were not genuine and that the whole transaction of alleged purchase by ABC Ltd. was bogus and that the entry made in the trade account as a liability was only a paper entry. The Assessing Officer, therefore, took the entire liability shown as cash credit as income of ABC Ltd. ABC Ltd., however, contended that section 68 can be invoked only in respect of cash entries and not otherwise. Is the contention of ABC Ltd. correct?

Answers

8. The Madras High Court in *CIT v. Henkel Spic India Ltd. (2004) 139 Taxman 40* observed that until the allotment process was complete, the application money and the interest due thereon would remain with a trust in favour of the general body of the applicants. The prohibition incorporated in section 73(3A) of the Companies Act, 1956 was absolute and the amount so deposited cannot be transferred to any other account. The amount of interest earned on application money, to the extent to which it is not required for being paid to the applicants to whom moneys have become refundable by reason of delay in making refund, will belong to the company only when the trust terminates and it is only at that point of time that the amount can be said to have accrued to the company.

In this case, since the process of allotment was completed only in the next year, the interest can be said to have accrued in the next year only. Therefore, the Assessing Officer was not correct in bringing to tax interest earned on such deposit in the current assessment year.

9. The claim of the firm for deduction of the sum of Rs.60,000 in computing its business income is not tenable. The action of the Assessing Officer in making the addition of Rs.60,000, being the payment of rent not debited in the books of account (for which the firm failed to explain the source of payment) is correct in law since the same is an unexplained expenditure under section 69C. The proviso to section 69C states that such unexplained expenditure, which is deemed to be the income of the assessee, shall not be allowed as a deduction under any head of income. Therefore, the claim of the firm is not tenable.

10. This issue has been resolved by the Madhya Pradesh High Court, in *V.I.S.P. (P.) Ltd. v. CIT (2004) 136 Taxman 482,* where it held that if the liability shown in the accounts is found to be bogus and no plausible and reasonable explanation is offered by the assessee, the amount can be added towards the income of the assessee and brought to tax in the hands of the assessee.

Therefore, ABC Ltd. is not correct in contending that section 68 can be invoked only in respect of cash entries.

2

RESIDENCE AND SCOPE OF TOTAL INCOME

2.1 RESIDENTIAL STATUS [SECTION 6]

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

For all purposes of income-tax, taxpayers are classified into three broad categories on the basis of their residential status. viz

(1) Resident and ordinarily resident

(2) Resident but not ordinarily resident

(3) Non-resident

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

(1) Residential status of Individuals

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

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

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

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

2.2 Income Tax

Note:

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

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

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

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

Exceptions:

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

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

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

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

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

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

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

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

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

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

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

Illustration 1

Steve Waugh, the Australian cricketer comes to India for 100 days every year. Find out his residential status for the A.Y. 2010-11.

Solution

For the purpose of his residential status in India for A.Y. 2010-11, the relevant previous year is 2009-10.

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

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

Therefore, the residential status of Steve Waugh for the assessment year 2010-11 is resident but not ordinarily resident.

Illustration 2

Mr. B, a Canadian citizen, comes to India for the first time during the P.Y.2005-06. During the financial years 2005-06, 2006-07, 2007-08, 2008-09 and 2009-10, he was in India for 55 days, 60 days, 90 days, 150 days and 70 days respectively. Determine his residential status for the A.Y.2010-11.

Solution

During the previous year 2009-10, Mr. B was in India for 70 days and during the 4 years preceding the previous year 2009-10, he was in India for 355 days (i.e. 55+ 60+ 90+ 150 days).

Thus, he does not satisfy section 6(1). Therefore, he is a non-resident for the previous year 2009-10.

2.4 Income Tax

Illustration 3

Mr. C, a Japanese citizen left India after a stay of 10 years on 1.06.2007. During the financial year 2008-09, he comes to India for 46 days. Later, he returns to India for 1 year on 10.10.2009. Determine his residential status for the A.Y. 2010-11.

Solution

During the previous year 2009-10, Mr. C was in India for 173 days (i.e. 22+ 30+ 31+ 31+ 28+ 31 days). His stay in the last 4 years is:

2008-09	-	46	
2007-08	-	62	(i.e. 30 + 31 + 1)
2006-07	-	365	(since he left India on 01.06.2007 after 10 years)
2005-06	-	365	(since he left India on 01.06.2007 after 10 years)
		838	

Mr. C is a resident since his stay in the previous year 2009-10 is 173 days and in the last 4 years is more than 365 days.

For the purpose of being ordinarily resident, it is evident from the above calculations, that

(i) his stay in the last 7 years is more than 730 days and

(ii) since he was in India for 10 years prior to 1.6.2007, he was a resident in at least 2 out of the last 10 years preceding the relevant previous year.

Therefore, Mr.C is a resident and ordinarily resident for the A.Y.2010-11.

Illustration 4

Mr. D, an Indian citizen, leaves India on 22.9.2009 for the first time, to work as an officer of a company in France. Determine his residential status for the A.Y. 2010-11.

Solution

During the previous year 2009-10, Mr. D, an Indian citizen, was in India for 175 days (i.e. 30+ 31+ 30+31+ 31+22 days). He does not satisfy the minimum criteria of 182 days. Also, since he is an Indian citizen leaving India for the purposes of employment, the second condition under section 6(1) is not applicable to him.

Therefore, Mr. D is a non-resident for the A.Y.2010-11.

(2) Residential status of HUF

A HUF would be resident in India if the control and management of its affairs is situated wholly or partly in India. If the control and management of the affairs is situated wholly outside India it would become a non-resident.

The expression 'control and management' referred to under section 6 refers to the central

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

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

Illustration 5

The business of a HUF is transacted from Australia and all the policy decisions are taken there. Mr. E, the karta of the HUF, who was born in Kolkata, visits India during the P.Y.2009-10 after 15 years. He comes to India on 1.4.2009 and leaves for Australia on 1.12.2009. Determine the residential status of Mr.E and the HUF for A.Y. 2010-11.

Solution

(a) During the P.Y.2009-10, Mr. E has stayed in India for 245 days (i.e. 30+31+30+31+31+ 30+31+30+1 days). Therefore, he is resident. However, since he has come to India after 15 years, he cannot satisfy any of the conditions for being ordinarily resident.

Therefore, the residential status of Mr. E for the P.Y. 2009-10 is resident but not ordinarily resident.

(b) Since the business of the HUF is transacted from Australia and nothing is mentioned regarding its control and management, it is assumed that the control and management is also wholly outside India. Therefore, the HUF is a non-resident for the P.Y. 2009-10.

(3) Residential status of firms and association of persons

A firm and an AOP would be resident in India if the control and management of its affairs is situated wholly or partly in India. Where the control and management of the affairs is situated wholly outside India, the firm would become a non-resident.

(4) Residential status of companies

A company is said to be resident in India if -

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

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

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

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

(5) Residential status of local authorities and artificial juridical persons

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

2.2 SCOPE OF TOTAL INCOME

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

(i) the residential status of the assessee (as discussed earlier);

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

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

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

(1) Resident and ordinarily resident - The total income of a resident assessee would, under section 5(1), consists of:

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

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

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

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

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

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

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

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

Note:

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

RESIDENT AND ORDINARILY RESIDENT	RESIDENT BUT NOT ORDINARILY RESIDENT	NON-RESIDENT
Income received/ deemed to be received/ accrued or arisen/deemed to accrue or arise in or outside India.	Income which is received/ deemed to be received/ accrued or arisen/deemed to accrue or arise in India. and Income which accrues or arises outside India being derived from a business controlled from or profession set up in India.	Income received/ deemed to be received/ accrued or arisen/deemed to accrue or arise in India.

2.3 DEEMED RECEIPT AND ACCRUAL OF INCOME IN INDIA

The taxability of a certain item as income would depend upon the method of accounting followed by the assessee. This is because under the cash system of accounting an income would be taxable only when it is received by the assessee himself or on his behalf. But under the mercantile system it would be taxable once the assessee gets the legal right to claim the amount. However, it has been specifically provided that in the case of income from salaries, the liability to tax arises immediately when the income is due to the assessee irrespective of the method of accounting followed. Likewise, in the case of

dividends, the income would be included in total income of the shareholder under section 8 in the year in which the final dividend is declared and, in the case of interim dividend, in the year in which they are made unconditionally available to the shareholders.

2.4 MEANING OF "INCOME RECEIVED OR DEEMED TO BE RECEIVED"

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

(i) their residential status, and

(ii) the place of its accrual.

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

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

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

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

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

2.5 MEANING OF INCOME 'ACCRUING' AND 'ARISING'

Accrue refers to the right to receive income, whereas due refers to the right to enforce payment of the same. For e.g. salary for work done in December will accrue throughout the month, day to day, but will become due on the salary bill being passed on 31st December or 1st January. Similarly, on Government securities, interest payable on specified dates arise during the period of holding, day to day, but will become due for payment on the specified dates. Example: Interest on Government securities is usually payable on specified dates, say on 1st January and 1st July. In all such cases, the interest would be said to accrue from 1st July to 31st December and on 1st January, it will fall due for payment.

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

With a view to removing difficulties and clarifying doubts in the taxation of income, *Explanation* 1 to Section 5 specifically provides that an item of income accruing or arising outside India shall not be deemed to be received in India merely because it is taken into account in a balance sheet prepared in India.

Further, *Explanation* 2 to Section 5 makes it clear that once an item of income is included in the assessee's total income and subjected to tax on the ground of its accrual/deemed accrual or receipt, it cannot again be included in the person's total income and subjected to tax either in the same or in a subsequent year on the ground of its receipt - whether actual or deemed.

2.6 INCOME DEEMED TO ACCRUE OR ARISE IN INDIA [SECTION 9]

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

(i) Any income accruing or arising to an assessee in any place outside India whether directly or indirectly (a) through or from any business connection in India, (b) through or from any property in India, (c) through or from any asset or source of income in India or (d) through the transfer of a capital asset situated in India.

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

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

(iv) Dividend paid by a Indian company outside India.

(v) Interest (discussed in para 5 below)

(vi) Royalty (discussed in para 6 below)

(vii) Fees for technical services (discussed in para 7 below)

(1)(a) Income from business connection

The expression "business connection" has been explained in *Explanation 2* to section 9(1)(i).

2.10 Income Tax

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

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

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

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

Exception:

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

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

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

(1) (b) &(c) Income from property, asset or source of income

Any income which arises from any property (movable, immovable, tangible and intangible property) would be deemed to accrue or arise in India eg. hire charges or rent paid outside India for the use of the machinery or buildings situated in India, deposits with an Indian company for which interest is received outside India etc.

(1)(d) Income from the transfer of a capital asset

Capital gains arising from the transfer of a capital asset situated in India would be deemed to accrue or arise in India in all cases irrespective of the fact whether (i) the capital asset is movable or immovable, tangible or intangible; (ii) the place of registration

of the document of transfer etc., is in India or outside; and (iii) the place of payment of the consideration for the transfer is within India or outside.

(2) & (3) Income from salaries

Under section 9(1)(ii) income which falls under the head 'salaries', would be deemed to accrue or arise in India, if it is in respect of services rendered in India.

Exception under section 9(2):

Pension payable outside India by the Government to its officials and judges who permanently reside outside India shall not be deemed to accrue or arise in India. It may however, be noted here that the salary of an employee in the United Nations Organisation (UNO) or in its constituent bodies is exempt under United Nations (Privilege and Immunity) Act.

(4) Income from dividends

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

(5) Interest

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

(i) the Central Government or any State Government.

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

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

(6) Royalty

Royalty will be will be deemed to accrue or arise in India when it is payable by -

(i) the Government; or

(ii) a person who is a resident in India except in cases where it is payable for the transfer of any right or the use of any property or information or for the utilization of

services for the purposes of a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India; or

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

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

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

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

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

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

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

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

(v) the use or right to use any industrial, commercial or scientific equipment but not including the amounts referred to in section 44BB;

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

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

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

(7) Fees for technical services

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

(i) the Government.

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

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

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

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

Explanation to section 9 clarifies that income by way of interest, royalty or fee for technical services which is deemed to accrue or arise in India by virtue of clauses (v), (vi) and (vii) of section 9(1), shall be included in the total income of the non-resident, whether or not the non-resident has a residence or place of business or business connection in India.

Illustration 6

Determine the taxability of the following incomes in the hands of a resident and ordinarily resident, resident but not ordinarily resident, and non-resident for the A.Y. 2010-11.

Particulars	Amount (Rs.)
Interest on UK Development Bonds, 50% of interest received in India	10,000
Income from a business in Chennai (50% is received in India)	20,000
Profits on sale of shares of an Indian company received in London	20,000
Dividend from British company received in London	5,000

2.14 Income Tax

Profits on sale of plant at Germany 50% of profits are received in India	40,000
Income earned from business in Germany which is controlled from Delhi (Rs.40,000 is received in India)	70,000
Profits from a business in Delhi but managed entirely from London	15,000
Rent from property in London deposited in a Indian Bank at London, brought to India	50,000
Interest for debentures in an Indian company received in London.	12,000
Fees for technical services rendered in India but received in London	8,000
Profits from a business in Bombay managed from London	26,000
Pension for services rendered in India but received in Burma	4,000
Income from property situated in Pakistan received there	16,000
Past foreign untaxed income brought to India during the previous year	5,000
Income from agricultural land in Nepal received there and then brought to India	18,000
Income from profession in Kenya which was set up in India, received there but spent in India	5,000
Gift received on the occasion of his wedding	20,000
Interest on savings bank deposit in State Bank of India	10,000
Income from a business in Russia, controlled from Russia	20,000
Dividend from Reliance Petroleum Limited, an Indian Company	5,000
Agricultural income from a land in Rajasthan	15,000

Solution:

Computation of total income for the A.Y.2010-11

Particulars	Resident and ordinarily resident	Resident but not ordinarily resident	Non-resident
Interest on UK Development Bonds, 50% of interest received in India	10,000	5,000	5,000
Income from a business in Chennai (50% is received in India)	20,000	20,000	20,000

Profits on sale of shares of an Indian company received in London	20,000	20,000	20,000
Dividend from British company received in London	5,000	-	-
Profits on sale of plant at Germany 50% of profits are received in India	40,000	20,000	20,000
Income earned from business in Germany which is controlled from Delhi, out of which Rs.40,000 is received in India	70,000	70,000	40,000
Profits from a business in Delhi but managed entirely from London	15,000	15,000	15,000
Rent from property in London deposited in a Bank at London, later on remitted to India	50,000	-	-
Interest for debentures in an Indian company received in London.	12,000	12,000	12,000
Fees for technical services rendered in India but received in London	8,000	8,000	8,000
Profits from a business in Bombay managed from London	26,000	26,000	26,000
Pension for services rendered in India but received in Burma	4,000	4,000	4,000
Income from property situated in Pakistan received there	16,000	-	-
Past foreign untaxed income brought to India during the previous year	-	-	-
Income from agricultural land in Nepal received there and then brought to India	18,000	-	-
Income from profession in Kenya which was set up in India, received there but spent in India	5,000	5,000	-
Gift received on the occasion of his wedding [not an income]	-	-	-
Interest on savings bank deposit in State Bank of India	10,000	10,000	10,000

Income from a business in Russia, controlled from Russia	20,000	-	-
Dividend from Reliance Petroleum Limited, an Indian Company [it is exempt u/s 10(34)]	-	-	-
Agricultural income from a land in Rajasthan [it is exempt u/s 10(1)]	-	-	-
Total Income	**3,49,000**	**2,15,000**	**1,80,000**

Self-examination questions

1. When is an individual said to be "Resident and ordinarily resident" under the Income-tax Act, 1961?
2. How is royalty defined under section 9 of the Income-tax Act?
3. Write short notes on -
   a) Business connection
   b) Income deemed to accrue or arise in India.
4. Discuss the provisions relating to determination of residential status of individuals.
5. When are the following income deemed to accrue or arise in India?
   a) Interest
   b) Fees for technical services.
6. During the previous year 2009-10, Abhinav had the following income:

		Rs.
(a)	Salary income received in India for services rendered in Nepal	15,000
(b)	Income from profession in India, but received in France.	10,000
(c)	Property income in Belgium (out of which Rs.6,000 was remitted to India).	9,000
(d)	Profits earned from business in Hyderabad.	8,000
(e)	Profits from a business carried on at Nepal but controlled from India.	25,000
(f)	Past untaxed profits remitted to India during the previous year 2008-09.	75,000

   Compute his income for assessment year 2010-11 if he is (i) resident and ordinarily resident, (ii) Not ordinarily resident, and (iii) Non-resident in India.

7. Mr. Aakash earns the following income during the previous year 2009-10. Compute his total income for A.Y.2010-11 if he is (i) resident and ordinarily resident; (ii) resident but not ordinarily resident; (iii) non-resident.

	Particulars	Rs.
(a)	Profits from a business in Ranchi managed from Canada	23,000
(b)	Income from property in Canada received there	36,000
(c)	Income from agricultural land in Nepal received there and remitted to India later on.	33,500
(d)	Interest on debentures in an Indian company received in Canada	6,200
(e)	Income from profession in Canada which was set up in Patna, received there.	42,000
(f)	Profits earned from business in Canada which is controlled from Jamshedpur, 25% of the profits being received in Jamshedpur	80,000
(g)	Fees for technical services rendered in Patna but received in Canada	25,000
(h)	Untaxed foreign income of earlier years brought to India	15,500
(i)	Dividend from a Canadian company received in Canada	14,000
(j)	Interest on development bonds issued in Canada, 40% of interest received in Patna	20,000

8. Mr. A, a citizen of India, left for USA for the purposes of employment on 1.5.2009. He has not visited India thereafter. Mr. A borrows money from his friend Mr. B, who left India one week before Mr. A's departure, to the extent of Rs.10 lakhs and buys shares in X Ltd., an Indian company. Discuss the taxability of the interest charged @10% in B's hands where the same has been received in New York.

Answer

6. (i) Rs.67,000; (ii) Rs.58,000; (iii) Rs.33,000.

7. (i) Rs.2,79,700; (ii) Rs.1,84,200; (iii) Rs.82,200.

8. An individual is said to be resident in India in any previous year, if he -

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

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

In this case, A has been in India only from 1.4.2009 to 30.04.2009 i.e. for 30 days. Therefore, he does not satisfy either of the conditions in (i) or (ii) and is, hence, a non-resident. B, who left India one week before A's departure, is also a non-resident for the same reasons.

2.18 Income Tax

Section 9(1)(v) provides that income by way of interest payable by a non-resident in respect of any debt incurred, or moneys borrowed and used, for the purposes of a business or profession carried on by such person in India shall be deemed to accrue or arise in India.

Therefore, interest payable by a non-resident in respect of any debt incurred, or moneys borrowed and used, for the purpose of making or earning any income from any source other than a business or profession carried on by him in India, shall not be deemed to accrue or arise in India. Therefore, interest payable by A on money borrowed from B to invest in shares of an Indian company shall not be deemed to accrue or arise in India and hence, is not taxable in India in the hands of B.

3

INCOMES WHICH DO NOT FORM PART OF TOTAL INCOME

3.1 INTRODUCTION

In this chapter, we are going to study section 10 which enumerates the various categories of income that are exempt from tax. Thereafter, we shall also consider sections 10A, 10AA, 10B, 10BA which deal with exemption in respect of income of industrial units in free trade zones, special economic zones, 100% EOUs and undertakings engaged in export of certain articles or things. Section 11 provides exemption in respect of income derived from property held under trust wholly for charitable or religious purposes. Section 13A exempts certain categories of income derived by a political party.

3.2. INCOMES NOT INCLUDED IN TOTAL INCOME [SECTION 10]

The various items of income referred to in the different clauses of section 10 are excluded from the total income of an assessee. These incomes are known as exempted incomes. Consequently, such income shall not enter into the computation of taxable income or the rate of tax.

Restrictions on allowability of expenditure [Section 14A] – (i) As per section 14A, expenditure incurred in relation to any exempt income is not allowed as a deduction while computing income under any of the five heads of income [Sub-section (1)].

However, the Assessing Officer is not empowered to reassess under section 147 or to pass an order increasing the liability of the assessee by way of enhancing the assessment or reducing a refund already made or otherwise increase the liability of the assessee under section 154, for any assessment year beginning on or before 1.4.2001 i.e. for any assessment year prior to A.Y. 2002-03 [Proviso to sub-section (1)].

The Assessing Officer is empowered to determine the amount of expenditure incurred in relation to such income which does not form part of total income in accordance with such method as may be prescribed [Sub-section (2)].

The method for determining expenditure in relation to exempt income is to be prescribed by the CBDT for the purpose of disallowance of such expenditure under section 14A. Such

method should be adopted by the Assessing Officer if he is not satisfied with the correctness of the claim of the assessee, having regard to the accounts of the assessee.

Further, the Assessing Officer is empowered adopt such method, where an assessee claims that no expenditure has been incurred by him in relation to income which does not form part of total income [Sub-section (3)].

Rule 8D lays down the method for determining the amount of expenditure in relation to income not includible in total income.

If the Assessing Officer, having regard to the accounts of the assessee of a previous year, is not satisfied with –

(a) the correctness of the claim of expenditure by the assessee; or

(b) the claim made by the assessee that no expenditure has been incurred in relation to exempt income for such previous year,

he shall determine the amount of expenditure in relation to such income in the manner provided hereunder –

The expenditure in relation to income not forming part of total income shall be the aggregate of the following:

(i) the amount of expenditure directly relating to income which does not form part of total income;

(ii) in a case where the assessee has incurred expenditure by way of interest during the previous year which is not directly attributable to any particular income or receipt, an amount computed in accordance with the following formula, namely :

$$A \times \frac{B}{C}$$

Where,

A = amount of expenditure by way of interest other than the amount of interest included in clause (i) incurred during the previous year;

B = the average of value of investment, income from which does not or shall not form part of the total income, as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year;

C = the average of total assets as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year;

'Total assets' means total assets as appearing in the balance sheet excluding the increase on account of revaluation of assets but including the decrease on account of revaluation of assets.

(iii) an amount equal to one-half per cent of the average of the value of investment, income

from which does not or shall not form part of the total income, as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year.

Difference between Section 10 and Chapter VI-A deductions - Certain other incomes are also wholly or partly rendered tax-free by being allowed as deductions in computation of total income under Chapter VI-A. Students should note a very important difference between exemptions under section 10 and the deductions under Chapter VI-A. While the incomes which are exempt under section 10 will not be included for computing total income, incomes from which deductions are allowable under Chapter VI-A will first be included in the gross total income (GTI) and then the deductions will be allowed. Let us now see the various incomes that are exempt from tax and the conditions to be satisfied in order to be eligible for exemptions.

(1) Agricultural income [Section 10(1)] – (i) Section 10(1) provides that agricultural income is not to be included in the total income of the assessee. The reason for totally exempting agricultural income from the scope of central income tax is that under the Constitution, the Parliament has no power to levy a tax on agricultural income.

(ii) **Indirect way of taxing agricultural income -** However, a method has been laid down to levy tax on agricultural income in an indirect way. This concept is known as partial integration of taxes. It is applicable to individuals, HUF, unregistered firms, AOP, BOI and artificial persons. Two conditions which need to satisfied for partial integration are:

1. The net agricultural income should exceed Rs.5,000 p.a., and
2. Non-agricultural income should exceed the maximum amount not chargeable to tax. (i.e. *Rs.2,40,000* for senior citizens, *Rs.1,90,000* for women assessees below 65 years of age, *Rs.1,60,000* for all other individuals.)

It may be noted that aggregation provisions do not apply to company, firm assessed as such (FAS), co-operative society and local authority. The object of aggregating the net agricultural income with non-agricultural income is to tax the non-agricultural income at higher rates.

Tax calculation in such cases is as follows:

Step 1: Add non-agricultural income with net agricultural income. Compute tax on the aggregate amount.

Step 2: Add net agricultural income and the maximum exemption limit available to the assessee (i.e. *Rs.1,60,000 / Rs.1,90,000 / Rs.2,40,000*). Compute tax on the aggregate amount.

Step 3: Deduct the amount of income tax calculated in step 2 from the income tax calculated in step 1 i.e. Step 1 – Step 2.

Step 4: The sum so arrived at shall be increased by education cess @2% and secondary and higher education cess @1%.

The above concept can be clearly understood with the help of the following illustrations:

Illustration 1

Mr. X, a resident, has provided the following particulars of his income for the P.Y.2009-10.

i. Income from salary (computed) - Rs.2,40,000

ii. Income from house property (computed) - Rs.2,00,000

iii. Agricultural income from a land in Jaipur - Rs.1,80,000

iv. Expenses incurred for earning agricultural income - Rs.1,20,000

Compute his tax liability assuming his age is -

(a) 45 years

(b) 70 years

Solution

Computation of total income of Mr.X for the A.Y.2010-11

Particulars	Amount (Rs.)	Amount (Rs.)
Income from salary		2,40,000
Income from house property		2,00,000
Net agricultural income [Rs.1,80,000 – Rs.1,20,000]	60,000	
Less: Exempt under section 10(1)	(60,000)	-
Gross Total Income		**4,40,000**
Less: Deductions under Chapter VI-A		-
Total Income		**4,40,000**

(a) Computation of tax liability (age 45 years)

For the purpose of partial integration of taxes, Mr. X has satisfied both the conditions i.e.

1. Net agricultural income exceeds Rs.5,000 p.a., and

2. Non agricultural income exceeds the basic exemption limit of *Rs.1,60,000*.

His tax liability is computed in the following manner:

Step 1: Rs.4,40,000 + Rs.60,000 = Rs.5,00,000.

Tax on Rs.5,00,000 = Rs.54,000

Step 2: Rs.60,000 + Rs.1,60,000 = Rs.2,20,000.

Tax on Rs.2,20,000 = Rs.6,000 (i.e. 10% of Rs.60,000)

Step 3 : Rs.54,000 – Rs.6,000 = Rs.48,000.

Step 4 : Total tax payable = Rs.48,000 + 2% of Rs.48,000 + 1% of Rs.48,000= Rs.49,440.

(b) Computation of tax liability (age 70 years)

For the purpose of partial integration of taxes, Mr. X has satisfied both the conditions i.e.

1. Net agricultural income exceeds Rs.5,000 p.a., and
2. Non-agricultural income exceeds the basic exemption limit of *Rs.2,40,000*.

His tax liability is computed in the following manner:

Step 1: Rs.4,40,000 + Rs.60,000= Rs.5,00,000.

Tax on Rs.5,00,000 = Rs.46,000 (i.e. Rs.6,000 + 20% of Rs.2,00,000)

Step 2: Rs.60,000 + Rs.2,40,000 = Rs.3,00,000.

Tax on Rs.3,00,000 = Rs.6,000 (i.e. 10% of Rs.60,000)

Step 3: Rs.46,000 – Rs.6,000 = Rs.40,000.

Step 4: Total tax payable = Rs.40,000 + 2% of Rs.40,000 + 1% of Rs.40,000= Rs.41,200.

(iii) Definition of agricultural income [Section 2(1A)]

This definition is very wide and covers the income of not only the cultivators but also the land holders who might have rented out the lands. Agricultural income may be received in cash or in kind.

Three ways: Agricultural income may arise in any one of the following three ways:-

(1) It may be rent or revenue derived from land situated in India and used for agricultural purposes.

(2) It may be income derived from such land through agriculture or the performance of a process ordinarily employed by a cultivator or receiver of rent in kind to render the produce fit to be taken to the market or through the sale of such agricultural produce in the market.

(3) Lastly, agricultural income may be derived from any farm building required for agricultural operations.

Now let us take a critical look at the following aspects:

(1) Land has to be situated in India - If agricultural lands are situated in a foreign State, the entire income would be taxable.

(2) "Agriculture" and "agricultural purposes" - These terms have not been defined in the Act. However, cultivation of a field involving expenditure of human skill and labour on the land can be broadly termed as agriculture.

(a) "Agriculture" means tilling of the land, sowing of the seeds and similar operations. These are basic operations and require the expenditure of human skill and labour on land itself. Those operations which the agriculturists have to resort to and which are absolutely necessary for the purpose of effectively raising produce from the land are the basic operations.

(b) Operations to be performed after the produce sprouts from the land (*e.g.,* weeding, digging etc.) are subsequent operations. These subsequent operations would be agricultural operations only when taken in conjunction with and as a continuation of the basic operations. Simply performing these subsequent operations without raising such products is not characterized as agriculture.

(c) "Agriculture" comprises within its scope the basic as well as the subsidiary operations regardless of the nature of the produce raised on the land. These produce may be grain, fruits or vegetables necessary for *sustenance* of human beings including plantation and groves or grass or pasture for consumption of beasts or articles of luxury such as betel, coffee, tea, spices, tobacco or commercial crops like cotton flax, jute hemp and indigo. The term comprises of products of land having some utility either for consumption or for trade and commerce and would include forest products such as sal, tendu leaves etc.

(d) However, the term 'agriculture' cannot be extended to all activities which have some distant relation to land like dairy farming, breeding and rearing of live stock, butter and cheese making and poultry farming. This aspect is discussed in detail later on.

(3) Income from nursery - In the past, there have been court rulings that only if a nursery is maintained by carrying out the basic operations on land and subsequent operations in continuation thereof, income from such nursery would be treated as agricultural income and would qualify for exemption under section 10(1). The Supreme Court has, in *CIT v. Raja Benoy Kumar Sahas Roy (1957) 32 ITR 466*, held that the basic operations must be performed before any income can be called agricultural income. The basic operations involve cultivation of the ground, in the sense of tilling of the land, sowing of the seeds, planting and other similar operations on the land. Such basic operations demand the expenditure of human labour and skill upon the land itself and further, they are directed to make the crop sprout from the land. Therefore, income derived from sale of plants grown directly in pots would not be treated as agricultural income.

However, the Madras High Court, in *CIT v. Soundarya Nursery (2000) 241 ITR 530*, observed that nursing activity involves carrying out of several operations on land before the saplings were transplanted in suitable containers including pots and thereafter kept in shade or green house for further operation and growth. Therefore, income arising from nursery should be considered as agricultural income.

Explanation 3 to section 2(1A) provides that, with effect from A.Y.2009-10, the income derived from saplings or seedlings grown in a nursery would be deemed to be agricultural income, whether or not the basic operations were carried out on land. This Explanation ratifies the view taken by the Madras High Court in favour of the taxpayer.

(4) Process ordinarily employed - The process to which the agricultural produce is subject should be a process which is ordinarily employed by a cultivator. It may be manual or mechanical. However, it must be employed to render the produce fit to be taken to the market. For example, before making rice fit to be taken to the market we have to remove the basic grain from the hay, we have to remove the chaff from the grain, we have to properly filter them, we have to remove stones etc. and we have to pack the grain in gunny bags. In that condition alone the rice can be taken to the market and sold. This process of making the rice ready for the market may involve manual operations or mechanical operations. All these operations constitute the process ordinarily employed to make the product fit for the market. The produce must retain its original character in spite of the processing unless there is no market for selling it in that condition.

Explanation regarding gains arising on the transfer of urban agricultural land - the capital gains arising from the transfer of such urban agricultural land would not be treated as agricultural income under section 10 but will be taxable under section 45. Urban area means any area which is within the jurisdiction of a municipality or cantonment board having a population of atleast 10,000 and any area outside the limits of such municipality or cantonment board but within a maximum distance of 8 km. from such limits as notified by the Central Government. In other words,

Example: Suppose A sells agricultural land situated in New Delhi for Rs. 10 lakh and makes a surplus of Rs.8 lakh over its cost of acquisition. This surplus will not constitute agricultural income exempt under section 10(1) and will be taxable under section 45.

(5) Income from farm building - Income from any farm building which satisfies the following conditions would be agricultural income and would consequently be exempt from tax:

(a) The building should be on or in the immediate vicinity of the agricultural land;

(b) It should be owned and occupied by the receiver of the rent or revenue of any such land or occupied by the cultivator or the receiver of rent in kind of any land with respect to which land or the produce of which land the process discussed above is carried on;

(c) The receiver of the rent or revenue or the cultivator or the receiver of rent in kind should, by

reason of his connection with such land require it as a dwelling house or other out building.

In addition to the above three conditions any one of the following two conditions should also be satisfied:

(i) The land should either be assessed to land revenue in India or be subject to a local rate assessed and collected by the officers of the Government as such or;

(ii) Where the land is not so assessed to land revenue in India or is not subject to local rate:-

(a) It should not be situated in any area as comprised within the jurisdiction of a municipality or a cantonment board and which has a population not less than 10,000.

(b) It should not be within 8 km. from the local limits of such municipality or cantonment board as notified by the Central Government

Income derived from any such building or land arising from any other use (other than those discussed above) shall not be agricultural income.

(iv) Indirect connection with the land - We have seen above that agricultural income is exempt, whether it is received by the tiller or the landlord. However, non-agricultural income does not become agricultural merely on account of its indirect connection with the land. The following examples will illustrate the above point.

1. A rural society had as its principal business the selling on behalf of its member societies, butter made by these societies from cream sold to them by farmers. The making of butter was a factory process separated from the farm. It was held that the butter resulting from the factory operations separated from the farm was not an agricultural product and the society was, therefore, not entitled to exemption from income tax.

2. X was the managing agent of a company. He was entitled for a commission at the rate of 10% p.a. on the annual net profits of the company. A part of the company's income was agricultural income. X claimed that since his remuneration was calculated with reference to income of the company, part of which was agricultural income, such part of the commission as was proportionate to the agricultural income was exempt from income tax. It was held that X received remuneration under a contract for personal service calculated on the amount of profits earned by the company and that remuneration was not an agricultural income.

3. Y owned 100 acres of agricultural land, a part of which was used as pasture for cows. The lands were purely maintained for manuring and other purposes connected with agriculture and only the surplus milk after satisfying the assessee's needs was sold. The question arose whether income from such sale of milk was agricultural income. It was held that the regularity with which the sales of milk were effected and quantity of milk sold showed that the assessee carried on regular business of producing milk and selling it as a commercial proposition. Hence, it was not agricultural income.

4. B was a shareholder in certain tea companies, 60% of whose income was exempt from tax as agricultural income. She claimed that 60% of the dividend received by her on her shares in those companies was also exempt from tax as agricultural income. It was held that dividend is derived from the investment made in the shares of the company and is not an agricultural income.

5. In regard to forest trees of spontaneous growth which grow on the soil unaided by any human skill and labour there is no cultivation of the soil at all. Even though operations in the nature of forestry operations performed by the assessee may have the effect of nursing and fostering the growth of such forest trees, it cannot constitute agricultural operations. Income from the sale of such forest trees of spontaneous growth do not, therefore, constitute agricultural income.

(v) For better understanding of the concept, certain examples of agricultural income and non-agricultural income are given below:

Agricultural income

1. Income derived from the sale of seeds.
2. Income from growing of flowers and creepers.
3. Rent received from land used for grazing of cattle required for agricultural activities.
4. Income from growing of bamboo.

Non-agricultural income

1. Income from breeding of livestock.
2. Income from poultry farming.
3. Income from fisheries.
4. Income from dairy farming.

(vi) Apportionment in certain cases - Where the agricultural produce like tea, cotton, tobacco, sugarcane etc. are subjected to a manufacturing process and the manufactured product is sold, the profit on such sales will consist of agricultural income as well as business income. That portion of the profit representing agricultural income will be exempted. For this purpose, rules 7, 7A, 7B & 8 of Income-tax Rules, 1962 provides the basis of apportionment.

(a) Rule 7 - Income from growing and manufacturing of any product other than tea - Where income is partially agricultural income and partially income chargeable to income-tax under the head 'profits and gains of business', the market value of any agricultural produce which has been raised by the assessee or received by him as rent in kind and which has been utilised as raw material in such business or the sale receipts of which are included in the accounts of the business shall be deducted. No further deduction shall be made in respect of any expenditure incurred by the assessee as a

cultivator or receiver of rent in kind.

Determination of market value - There are two possibilities here :

(a) The agricultural produce is capable of being sold in the market either in its raw stage or after application of any ordinary process to make it fit to be taken to the market. In such a case, the value calculated at the average price at which it has been so sold during the relevant previous year will be the market value.

(b) It is possible that the agricultural produce is not capable of being ordinarily sold in the market in its raw form or after application of any ordinary process. In such case the market value will be the total of the following:—

(i) The expenses of cultivation;

(ii) The land revenue or rent paid for the area in which it was grown; and

(iii) Such amount as the Assessing Officer finds having regard to the circumstances in each case to represent at reasonable profit.

Illustration 2

Mr. B grows sugarcane and uses the same for the purpose of manufacturing sugar in his factory. 30% of sugarcane produce is sold for Rs.10 lacs, and the cost of cultivation of such sugarcane is Rs.5 lacs. The cost of cultivation of the balance sugarcane (70%) is Rs.14 lacs and the market value of the same is Rs.22 lacs. After incurring Rs.1.5 lacs in the manufacturing process on the balance sugarcane, the sugar was sold for Rs.25 lacs. Compute B's business income and agricultural income.

Solution

Income from sale of sugarcane gives rise to agricultural income and from sale of sugar gives rise to business income.

Business income	=	Sales – Market value of 70% of sugarcane produce – Manufacturing expenses
	=	Rs.25 lacs – Rs.22 lacs - Rs.1.5 lacs
	=	Rs.1.5 lacs.
Agricultural income	=	Market value of sugarcane produce – Cost of cultivation
	=	[Rs10 lacs + Rs.22 lacs] – [Rs.5 lacs + Rs.14 lacs]
	=	Rs.32 lacs – Rs.19 lacs
	=	Rs.13 lacs.

(b) Rule 7A – Income from growing and manufacturing of rubber – This rule is applicable when income derived from the sale of latex or cenex or latex based crepes or

brown crepes manufactured from field latex or coagulum obtained from rubber plants grown by the seller in India. In such cases 35% profits on sale is taxable as business income under the head profits and gains from business or profession, and the balance 65% is agricultural income and is exempt.

Illustration 3

Mr. C manufactures latex from the rubber plants grown by him in India. These are then sold in the market for Rs.30 lacs. The cost of growing rubber plants is Rs.10 lacs and that of manufacturing latex is Rs.8 lacs. Compute his total income.

Solution

The total income of Mr. C comprises of agricultural income and business income.

Total profits from the sale of latex	= Rs.30 lacs – Rs.10 lacs – Rs.8 lacs.	
	= Rs.12 lacs.	
Agricultural income	= 65% of Rs.12 lacs.	= Rs.7.8 lacs
Business income	= 35% of Rs.12 lacs.	= Rs.4.2 lacs

(c) Rule 7B – Income from growing and manufacturing of coffee – (a) In case of income derived from the sale of coffee grown and cured by the seller in India, 25% profits on sale is taxable as business income under the head "Profits and gains from business or profession", and the balance 75% is agricultural income and is exempt. (b) In case of income derived from the sale of coffee grown, cured, roasted and grounded by the seller in India, with or without mixing chicory or other flavouring ingredients, 40% profits on sale is taxable as business income under the head "Profits and gains from business or profession", and the balance 60% is agricultural income and is exempt.

(d) Rule 8 - Income from growing and manufacturing of tea - This rule applies only in cases where the assessee himself grows tea leaves and manufactures tea in India. In such cases 40% profits on sale is taxable as business income under the head "Profits and gains from business or profession", and the balance 60% is agricultural income and is exempt.

(2) Amounts received by a member from the income of the HUF [Section 10(2)]

(i) As seen in the first Chapter, a HUF is a 'person' and hence a unit of assessment under the Act. Income earned by the HUF is assessable in its own hands.

(ii) In order to prevent double taxation of one and the same income, once in the hands of the HUF which earns it and again in the hands of a member when it is paid out to him, section 10(2) provides that members of a HUF do not have to pay tax in respect of any amounts received by them from the family.

(iii) The exemption applies only in respect of a payment made by the HUF to its member

(1) out of the income of the family or

(2) out of the income of the impartible estate belonging to the family.

(3) Share income of a partner [Section 10(2A)] - This clause exempts from tax a partner's share in the total income of the firm. In other words, the partner's share in the total income of the firm determined in accordance with the profit-sharing ratio will be exempt from tax.

(4) Exemption to non-residents and person resident outside India [Section 10(4)]
(i) This clause provides that in the case of a non-resident, any income by way of interest on Central Government securities as may be prescribed will be exempt. Even income by way of premium on the redemption of such bonds is exempt.

(ii) However, the Central Government shall not notify any such bonds or securities after 1.6.2002. Hence, this exemption will no more be available in respect of any further issue of bonds or securities on or after the 1.6.2002.

(iii) In the case of an individual who is a person resident outside India, as defined in FERA, 1973, any income by way of interest on moneys standing to his credit in a Non-resident (External) Account (NRE A/c) in any bank in India will be exempt, subject to fulfillment of certain conditions.

(iv) In this context, it may be noted that the joint holders of the NRE Accounts do not constitute an AOP by merely having these accounts in joint names. The benefit of exemption under section 10(4)(ii) will be available to such joint account holders, subject to fulfilment of other conditions contained in that section by each of the individual joint account holders.

(5) Interest on savings certificates [Section 10(4B)]

(i) An individual, being a citizen of India or a person of Indian origin, who is non-resident shall be entitled for exemption in respect of interest on such saving certificates issued before 1.6.2002 by the Central Government and notified by it in the Official Gazette in this behalf.

(ii) However, to claim such exemption, the individual should have subscribed to such certificates in convertible foreign exchange remitted from a country outside India in accordance with the provisions of the FERA.

(6) Leave travel concession [Section 10(5)]

(i) This clause exempts the leave travel concession (LTC) received by employees from their employers for proceeding to any place in India,

(a) either on leave or

(b) after retirement from service or

(c) after termination of his service.

(ii) The benefit is available to individuals - citizens as well as non-citizens - in respect of

travel concession or assistance for himself or herself and for his/her family- *i.e.,* spouse and children of the individual and parents, brothers and sisters of the individual or any of them wholly or mainly dependent on the individual.

(iii) Limit of exemption - The exemption in all cases will be limited to the amount actually spent subject to such conditions as specified in Rule 2B regarding the ceiling on the number of journeys for the place of destination.

Under Rule 2B the exemption will be available in respect of 2 journeys performed in a block of 4 calendar years commencing from the calendar year 1986. Where such travel concession or assistance is not availed by the individual during any block of 4 calendar years, one such unavailed LTC will be carried forward to the immediately succeeding block of 4 calendar years and will be eligible for exemption.

Example: An employee does not avail any LTC for the block 2002-05. He avails it during 2006. It is allowed to carry forward maximum one such holiday to be used in the succeeding block. Therefore, this will be eligible for exemption and two more journeys can be further availed.

(iv) Monetary limits

Where the journey is performed on or after the 1.10.1997, the amount exempted under section 10(5) in respect of the value of LTC shall be the amount actually incurred on such travel subject to the following conditions:

(1) where it is performed by air, an amount not exceeding the air economy fare of the National Carrier by the shortest route to the place of destination;

(2) where places of origin of journey and destination are connected by rail and the journey is performed by any mode of transport other than by air an amount not exceeding the air-conditioned first class rail fare by the shortest route to the place of destination; and

(3) where the places of origin of journey and destination or part thereof are not connected by rail, the amount eligible for exemption shall be,—

  (A) where a recognised public transport system exists, an amount not exceeding the 1st class or deluxe class fare, as the case may be, on such transport by the shortest route to the place of destination ; and

  (B) where no recognised public transport system exists, an amount equivalent to the air-conditioned first class rail fare, for the distance of the journey by the shortest route, as if the journey had been performed by rail.

Note: The exemption referred to shall not be available to more than two surviving children of an individual after 1.10.1998. This restrictive sub-rule shall not apply in respect of children born before 1.10.1998 and also in case of multiple births after one child.

Illustration 4

Mr. D went on a holiday on 25.12.2009 to Delhi with his wife and three children (one son – age 5 years; twin daughters – age 2 years). They went by flight (economy class) and the total cost of tickets reimbursed by his employer was Rs 60,000 (Rs 45,000 for adults and 15,000 for the three minor children). Compute the amount of LTC exempt.

Solution

Since the son's age is more than the twin daughters, Mr. D can avail exemption for all his three children. The restriction of two children is not applicable to multiple births after one child. The holiday being in India and the journey being performed by air (economy class), the entire reimbursement met by the employer is fully exempt.

Illustration 5

In the above illustration 4, will be there be any difference if among his three children the twins were 5 years old and the son 3 years old? Discuss.

Solution

Since the twins' age is more than the son, Mr. D cannot avail for exemption for all his three children. LTC exemption can be availed in respect of only two children. Taxable LTC = $\text{Rs}\,15{,}000 \times \frac{1}{3}$ = Rs.5,000 .

LTC exempt is only Rs.55,000 (i.e. Rs.60,000 – Rs.5,000)

(7) Exemption in the case of individuals, who are not citizens of India [Section 10(6)]- Individual assessees who are not citizens of India are entitled to certain exemptions:

(i) Section 10(6)(ii) grants exemption to a person in respect of the remuneration received by him for services as an official of an embassy, high commission, legation, consulate or the trade representation of a foreign State or as a member of the staff of any of these officials.

Conditions -

(a) The remuneration received by our corresponding Government officers resident in such foreign countries should be exempt.

(b) The above-mentioned officers should be the subjects of the respective countries and should not be engaged in any other business or profession or employment in India.

(ii) Section 10(6)(vi) provides that remuneration received by a foreign national as an employee of a foreign enterprise for service rendered by him during his stay in India is also exempt from tax.

Conditions -

(1) The foreign enterprise is not engaged in a business activity in India;

(2) The employee's stay in India does not exceed a total of 90 days in the previous year;

(3) The remuneration is not liable to be deducted from the employer's income chargeable to tax under the Act.

(iii) Section 10(6)(viii) provides that salary income received by or due to a non-citizen of India who is also non-resident for services rendered in connection with his employment on a foreign ship where his total stay in India does not exceed a total of 90 days in the previous year.

(iv) Section 10(6)(xi) provides that any remuneration received by employees of foreign Government from their respective Government during their stay in India in connection with their training in any establishment or office of the Government or any public sector undertaking is exempt from tax. For this purpose, the expression 'public sector undertaking' will cover Statutory Corporations; companies wholly owned by the Central Government or State Government or jointly by the Central and State Government and subsidiaries of such companies, societies registered under the Societies Registration Act, 1860 or any other similar law, which are wholly financed by the Central Government or State Government or jointly by the Central or State Government.

(8) Tax on royalty or fees for technical services derived by foreign companies [Section 10(6A)] - The benefit of exemption under this section is available to foreign companies only. As per this clause, tax paid by the Government or by an Indian concern on behalf of a foreign company is exempt in the hands of such foreign company provided all the following conditions are satisfied:

(i) Such tax must have been payable by the foreign company in respect of income received from the Government or the Indian concern by way of royalty or fees for technical services.

(ii) Such income by way of royalty or fees for technical services must have been received in pursuance of an agreement made by the foreign company with the Government or the Indian concern on or after 1.4.1976 but before 1.6.2002 and such agreement must have been approved by the Central Government. However, where the agreement relates to a subject matter which is included in the industrial policy of the Government and such agreement is in accordance with that policy, no approval of the Central Government is necessary.

(9) Tax paid on behalf of non-resident [Section 10(6B)] – This clause provides that the amount of tax paid by Government or an Indian concern on behalf of a non-resident or a foreign company in respect of its income will not be included in computing the total income of such non-resident or foreign company in pursuance of an agreement entered before 1.6.2002 between the Central Government and the Government of foreign State or an international organisation under the terms of that agreement or of any related agreement which has been

approved before 1.6.2002 by the Central Government.

(10) Tax paid on behalf of foreign state or foreign enterprise on amount paid as consideration of acquiring aircraft, etc. on lease [Section 10(6BB)] - Under this section, exemption is provided in respect of tax paid by an Indian company engaged in the business of operation of an aircraft, on income derived by the Government of a foreign State or a foreign enterprise as a consideration of acquiring an aircraft or aircraft engine on lease under an agreement entered into after 31.3.1997 but before 1.4.1999 or entered into after 31.3.2007 and approved by the Central Government

However, payment for providing spares, facilities or services in connection with the operation of leased aircraft is not covered under this clause.

(11) Income from projects connected with the security of India [Section 10(6C)] - Any income arising to such foreign company as the Central Government may notify, by way of fees for technical services received in pursuance of an agreement entered into with that Government for providing services in or outside India in projects connected with security of India will be exempt. Such exemption is also available in respect of royalty for technical services arising to the foreign company.

(12) Allowances payable outside India [Section 10(7)] - Allowances or perquisites paid or allowed as such outside India by the Government to a citizen of India for services rendered outside India are exempt from tax. Students may remember that in such cases under section 9(1)(ii), the income chargeable under the head 'Salaries' is deemed to accrue in India. The residential status of the recipient will, however, not affect this exemption.

(13) Co-operative technical assistance programmes [Sections 10(8) and (9)] - Individuals who are assigned duties in India in connection with any co-operative technical assistance programmes and projects would be exempt from tax on their receipts by way of:

(a) remuneration received directly or indirectly from the Government of a foreign State for rendering such services; and

(b) any other income accruing or arising outside India (but is not deemed to accrue or arise in India) in respect of which the individual is required to pay income-tax or other social security tax to the Government of that foreign State.

A similar exemption would be available under section 10(9) in respect of the income of any member of the family of any such individual referred to above provided that the income:

(i) actually accrues outside India;

(ii) cannot be deemed to accrue or arise in India; and

(iii) in respect of which such member is required to pay income or social security tax to the Government of that foreign State.

(14) Consultant remuneration [Sections 10(8A) and (8B)] - Under clause (8A), any remuneration or fee received by a consultant, directly or indirectly, out of the funds made available to an international organisation (agency) under a technical assistance grant agreement with the agency and Government of a foreign State is exempted from income-tax. The expression "Consultant" means any individual who is either not a citizen of India or, being a citizen of India, is resident but not ordinarily resident, or any other person who is a non-resident and is engaged by the agency for rendering technical services in India in accordance with an agreement entered into by the Central Government and the State agency and the agreement relating to the engagements of the consultant is approved by the prescribed authority.

Under clause (8B), the remuneration received by an employee of the consultant is exempted from income-tax provided such employee is either not a citizen of India or, being a citizen of India, is resident but not ordinarily resident and the contract of his service is approved by the prescribed authority before the commencement of his service.

Section 10(9) discussed above exempts the income of any member of the family of any such individual as is referred to in clauses (8A) and (8B) accompanying him to India, which accrues or arises outside India, and in respect of which such member is required to pay any income or social security tax to the country of his origin.

(15) Gratuity [Section 10(10)]

1. Retirement gratuity received under the Pension Code Regulations applicable to members of the Defence Service is fully exempt from tax.

2. **Central / State Government Employees**: Any death cum retirement gratuity is fully exempt from tax.

3. **Non-government employees covered by the Payment of Gratuity Act, 1972**

Any death cum retirement gratuity is exempt from tax to the extent of least of the following:

(i) Rs.3,50,000

(ii) Gratuity actually received

(iii) 15 days' salary based on last drawn salary for each completed year of service or part thereof in excess of 6 months

Note: Salary for this purpose means basic salary and dearness allowance. No. of days in a month for this purpose, shall be taken as 26.

4. **Non-government employees not covered by the Payment of Gratuity Act, 1972**

Any death cum retirement gratuity is exempt from tax to the extent of least of the following:

(i) Rs.3,50,000

(ii) Gratuity actually received

(iii) Half month's salary (based on last 10 months' average salary immediately preceding the month of retirement or death) for each completed year of service (fraction to be ignored)

Note: Salary for this purpose means basic salary and dearness allowance, if provided in the terms of employment for retirement benefits, forming part of salary and commission which is expressed as a fixed percentage of turnover.

Students must also note the following points:

(1) Gratuity received during the period of service is fully taxable.

(2) Where gratuity is received from 2 or more employers in the same year then aggregate amount of gratuity exempt from tax cannot exceed Rs.3,50,000.

(3) Where gratuity is received in any earlier year from former employer and again received from another employer in a later year, the limit of Rs.3,50,000 will be reduced by the amount of gratuity exempt earlier.

(4) The exemption in respect of gratuities would be available even if the gratuity is received by the widow, children or dependents of a deceased employee.

Illustration 6

Mr.Ravi retired on 15.6.2009 after completion of 26 years 8 months of service and received gratuity of Rs.6,00,000. At the time of retirement his salary was:

Basic Salary	:	Rs.5,000 p.m.
Dearness Allowance	:	Rs.3,000 p.m. (60% of which is for retirement benefits)
Commission	:	1% of turnover (turnover in the last 12 months was Rs.12,00,000)
Bonus	:	Rs.12,000 p.a.

Compute his taxable gratuity assuming:

(a) He is non-government employee and covered by the Payment of Gratuity Act 1972.

(b) He is non-government employee and not covered by Payment of Gratuity Act 1972.

(c) He is a Government employee.

Solution

(a) He is covered by the Payment of Gratuity Act 1972.

Gratuity received at the time of retirement	Rs.6,00,000
Less : Exemption under section 10(10) :	
Least of the following :	

i.	Gratuity received	Rs.6,00,000	
ii.	Statutory limit	Rs.3,50,000	
iii.	15 days salary based on last drawn salary for each completed year of service or part thereof in excess of 6 months		
	$\frac{15}{26} \times$ last drawn salary $\times$ years of service		
	$\frac{15}{26} \times (Rs.5,000 + Rs.3,000) \times 27 =$	Rs.1,24,615	Rs.1,24,615
	Taxable Gratuity		Rs.4,75,385

(b) He is not covered by the Payment of Gratuity Act 1972.

Gratuity received at the time of retirement	Rs.6,00,000
Less : Exemption under section 10(10) (note 1)	Rs.1,01,400
Taxable Gratuity	Rs.4,98,600

Note 1: Exemption under section 10(10) is least of the following :

i.	Gratuity received	Rs.6,00,000
ii.	Statutory limit	Rs.3,50,000
iii.	Half month's salary based on average salary of last 10 months preceding the month of retirement for each completed year of service.	
	i.e. $\frac{1}{2} \times$ Average salary $\times$ years of service	
	$= \frac{1}{2} \times \frac{\left[(5,000 \times 10) + (3,000 \times 60\% \times 10) + \left(1\% \times 12,00,000 \times \frac{10}{12}\right)\right]}{10} \times 26$	
	= Rs.1,01,400	

(c) He is a government employee

Gratuity received at the time of retirement	Rs.6,00,000
Less : Exemption under section 10(10)	Rs.6,00,000
Taxable gratuity	Nil

3.20 Income Tax

(16) Payment in commutation of pension [Section 10(10A)]

Pension is of two types: commuted and uncommuted.

Uncommuted Pension: Uncommuted pension refers to pension received periodically. It is fully taxable in the hands of both government and non-government employees.

Commuted Pension: Commuted pension means lump sum amount taken by commuting the whole or part of the pension. Its treatment is discussed below:

(a) Employees of the Central Government/local authorities/Statutory Corporation/ members of the Defence Services: Any commuted pension received is fully exempt from tax.

(b) Non-Government Employee : Any commuted pension received is exempt from tax in the following manner :

If the employee is in receipt of gratuity,

Exemption = 1/3rd of the amount of pension which he would have received had he commuted the whole of the pension.

$$= \left[\frac{1}{3} \times \frac{\text{commuted pension received}}{\text{commutation \%}} \times 100\%\right]$$

If the employee does not receive any gratuity

Exemption = ½ of the amount of pension which he would have received had he commuted the whole of the pension.

$$= \left[\frac{1}{2} \times \frac{\text{commuted pension received}}{\text{commutation \%}} \times 100\%\right]$$

Note:

1. Judges of the Supreme Court and High Court will be entitled to exemption of the commuted portion not exceeding ½ of the pension.
2. Any commuted pension received by an individual out of annuity plan of the Life Insurance Corporation of India (LIC) from a fund set up by that Corporation will be exempted.

Illustration 7

Mr. Sagar retired on 1.10.2009 receiving Rs.5,000 p.m. as pension. On 1.2.2010, he commuted 60% of his pension and received Rs.3,00,000 as commuted pension. You are required to compute his taxable pension assuming:

a. He is a government employee.

b. He is a non-government employee, receiving gratuity of Rs.5,00,000 at the time of retirement.

c. He is a non-government employee and is in receipt of no gratuity at the time of retirement.

Solution

(a) He is a government employee.

Uncommuted pension received (October – March)		Rs.24,000
[(Rs.5,000 × 4 months) + (40% of Rs.5,000 × 2 months)]		
Commuted pension received	Rs.3,00,000	
Less : Exempt u/s 10(10A)	Rs.3,00,000	NIL
Taxable pension		Rs 24,000

(b) He is a non-government employee, receiving gratuity Rs.5,00,000 at the time of retirement.

Uncommuted pension received (October – March)		Rs.24,000
[(Rs.5,000 × 4 months) + (40% of Rs.5,000 × 2 months)]		
Commuted pension received	Rs.3,00,000	
Less : Exempt u/s 10(10A)		
$\left(\frac{1}{3}\times\frac{Rs\,3,00,000}{60\%}\times 100\%\right)$	Rs.1,66,667	Rs.1,33,333
Taxable pension		Rs.1,57,333

(c) He is a non-government employee and is not in receipt of gratuity at the time of retirement.

Uncommuted pension received (October – March)		Rs.24,000
[(Rs.5,000 × 4 months) + (40% of Rs.5,000 × 2 months)]		
Commuted pension received	Rs.3,00,000	
Less : Exempt u/s 10(10A)		
$\left(\frac{1}{2}\times\frac{Rs\,3,00,000}{60\%}\times 100\%\right)$	Rs.2,50,000	Rs.50,000
Taxable pension		Rs.74,000

(17) Exemption of amount received by way of encashment of unutilised earned leave on retirement [Section 10(10AA)] - It provides exemption in respect of amount received by way

of encashment of unutilised earned leave by an employee at the time of his retirement whether on superannuation or otherwise. The provisions of this clause are mentioned below:

(a) Government employees: Leave salary received at the time of retirement is fully exempt from tax.

(b) Non-government employees: Leave salary received at the time of retirement is exempt from tax to the extent of least of the following :

(i) Rs.3,00,000

(ii) Leave salary actually received

(iii) 10 months' salary (on the basis of average salary of last 10 months)

(iv) Cash equivalent of leave (based on last 10 months' average salary immediately preceding the date of retirement) to the credit of the employee at the time of retirement or death (calculated at 30 days' credit for each completed year of service (fraction to be ignored)

Note:

1. Leave salary received during the period of service is fully taxable.

2. Where leave salary is received from two or more employers in the same year, then the aggregate amount of leave salary exempt from tax cannot exceed Rs.3,00,000.

3. Where leave salary is received in any earlier year from a former employer and again received from another employer in a later year, the limit of Rs.3,00,000 will be reduced by the amount of leave salary exempt earlier.

4. Salary for this purpose means basic salary and dearness allowance, if provided in the terms of employment for retirement benefits and commission which is expressed as a fixed percentage of turnover.

5. 'Average salary' will be determined on the basis of the salary drawn during the period of ten months immediately preceding the date of his retirement whether on superannuation or otherwise.

Illustration 8

Mr. Gupta retired on 1.12.2009 after 20 years 10 months of service, receiving leave salary of Rs.5,00,000. Other details of his salary income are:

Basic Salary	:	Rs.5,000 p.m. (Rs.1,000 was increased w.e.f. 1.4.09)
Dearness Allowance	:	Rs.3,000 p.m. (60% of which is for retirement benefits)
Commission	:	Rs.500 p.m.
Bonus	:	Rs.1,000 p.m.

Leave availed during service : 480 days

He was entitled to 30 days leave every year.

You are required to compute his taxable leave salary assuming:

(a) He is a government employee.

(b) He is a non government employee.

Solution

(a) He is a government employee.

Leave Salary received at the time of retirement	Rs 5,00,000
Less : Exemption under section 10(10AA)	Rs 5,00,000
Taxable Leave salary	Nil

(b) He is a non-government employee

Leave Salary received at the time of retirement	Rs.5,00,000
Less : Exempt under section 10(10AA) [note 1]	Rs. 26,400
∴ Taxable Leave Salary	Rs.4,73,600

Note 1 : Exemption under section 10(10AA) is least of the following:

(i)	Leave salary received	Rs.5,00,000
(ii)	Statutory limit	Rs.3,00,000
(iii)	10 months salary based on average salary of last 10 months	
	i.e. $\left[10 \times \frac{\text{Salary of last 10 months i.e. Feb - Nov}}{\text{10 months}}\right]$	
	$= \left[10 \times \frac{(5000 \times 8) + (4000 \times 2) + (60\% \times 3000 \times 10)}{\text{10 months}}\right]$	Rs.66,000

(iv) Cash equivalent of leave standing at the credit of the employee based on the average salary of last 10 months (max. 30 days per year of service)

Leave Due = Leave allowed – Leave taken

= (30 days per year × 20 years) – 480 days

= 120 days

$$\text{i.e. } \left[\frac{\text{Leave due (in days)}}{30 \text{ days}} \times \text{Average salary p.m.}\right]$$

$$= \left[\frac{120 \text{ days}}{30 \text{ days}} \times \frac{\text{Rs } 66{,}000}{10}\right] \qquad \text{Rs.26,400}$$

(18) Retrenchment compensation [Section 10(10B)] - Retrenchment compensation will be exempt from tax subject to the following limits:

(a) Amount calculated in accordance with the provisions of section 25F of the Industrial Disputes Act, 1947; or

(b) An amount, not less than Rs.5,00,000 as may be notified by the Central Government in this behalf,

whichever is lower.

The retrenchment compensation for this purpose means the compensation paid under Industrial Disputes Act, 1947 or under any Act, Rule, Order or Notification issued under any law. It also includes compensation paid on transfer of employment under section 25F or closing down of an undertaking under section 25FF of the Industrial Disputes Act, 1947.

The above limits will not be applicable to cases where the compensation is paid under any scheme approved by the Central Government for giving special protection to workmen under certain circumstances.

Illustration 9

Mr. Garg received retrenchment compensation of Rs.10,00,000 after 30 years 4 months of service. At the time of retrenchment, he was drawing basic salary Rs.20,000 p.m.; dearness allowance Rs.5,000 p.m. Compute his taxable retrenchment compensation.

Solution

Retrenchment compensation received	Rs.10,00,000
Less : Exemption under section10(10B) [Note 1]	Rs. 4,32,692
Taxable retrenchment compensation	Rs. 5,67,308

Note 1 : Exemption is to the extent of least of the following :

(i) Compensation actually received = Rs.10,00,000

(ii) Statutory Limit = Rs.5,00,000

(iii) Amount calculated in accordance with provisions of the Industrial Disputes Act, 1947

$$\text{i.e. } \frac{15}{26} \times \text{Avg salary of last 3 mths} \times \text{Completed yrs of service and part thereof in excess of 6 mths}$$

$$= \left[\frac{15}{26} \times \frac{(20,000 \times 3) + (5,000 \times 3)}{3} \times 30 \text{ years}\right] \qquad = \text{Rs.}4,32,692$$

(19) Payments to Bhopal Gas Victims [Section 10(10BB)] - Any payment made to a person under Bhopal Gas Leak Disaster (Processing of Claims) Act, 1985 and any scheme framed thereunder will be fully exempt. However, payments made to any assessee in connection with Bhopal Gas Leak Disaster to the extent he has been allowed a deduction under the Act on account of any loss or damage caused to him by such disaster will not be exempted.

(20) Exemption of compensation received on account of disaster [Section 10(10BC)]

(i) This clause exempts any amount received or receivable as compensation by an individual or his legal heir on account of any disaster.

(ii) Such compensation should be granted by the Central Government or a State Government or a local authority.

(iii) However, exemption would not be available in respect of compensation for alleviating any damage or loss, which has already been allowed as deduction under the Act.

(iv) "Disaster" means a catastrophe, mishap, calamity or grave occurrence in any area, arising from natural or man made causes, or by accident or negligence. It should have the effect of causing -

(1) substantial loss of life or human suffering; or

(2) damage to, and destruction of, property; or

(3) damage to, or degradation of, environment.

It should be of such a nature or magnitude as to be beyond the coping capacity of the community of the affected area.

(21) Voluntary Retirement Receipts [Section 10(10C)] - Compensation received by an employee at the time of voluntary retirement is exempt from tax subject to the following conditions :

Eligible Undertakings - The employee of the following undertakings are eligible for exemption under this clause :

(i) Public sector company

(ii) Any other company

(iii) An authority established under a Central/State or Provincial Act

(iv) A local authority

(v) A co-operative society

(vi) An University established or incorporated under a Central/State or Provincial Act and an Institution declared to be an University by the University Grants Commission.

(vii) An Indian Institute of Technology

(viii) Such Institute of Management as the Central Government may, by notification in the Official Gazette, specify in this behalf

(ix) Any State Government

(x) The Central Government

(xi) An institution, having importance throughout India or in any state or states, as the Central Government may specify by notification in the Official Gazette.

Limit : The maximum limit of exemption should not exceed Rs.5 lakh.

Such compensation should be at the time of his voluntary retirement or termination of his service, in accordance with any scheme or schemes of voluntary retirement or, in the case of public sector company, a scheme of voluntary separation. The exemption will be available even if such compensation is received in installments.

The schemes should be framed in accordance with such guidelines, as may be prescribed and should include the criteria of economic viability.

Guidelines

Rule 2BA prescribes the guidelines for the purposes of the above clause. They are as follows:

1. It applies to an employee of the company or the authority, as the case may be, who has completed 10 years of service or completed 40 years of age.

   However, this requirement is not applicable in case of an employee of a public sector company under the scheme of voluntary separation framed by the company.

2. It applies to all employees by whatever name called, including workers and executives of the company or the authority except directors of a company or a cooperative society.

3. The scheme of voluntary retirement or separation must have been drawn to result in overall reduction in the existing strength of the employees of a company or the authority or a cooperative society.

4. The vacancy caused by the voluntary retirement or separation must not be filled up.

5. The retiring employee of a company shall not be employed in another company or concern belonging to the same management.

6. The amount receivable on account of voluntary retirement or separation of the employee must not exceed the amount equivalent to three months' salary for each completed year of service or salary at the time of retirement multiplied by the balance months of service left before the date of his retirement or superannuation.

Note *- Where any relief has been allowed to any assessee under section 89 for any assessment year in respect of any amount received or receivable on his voluntary retirement*

or termination of service or voluntary separation, no exemption under section 10(10C) shall be allowed to him in relation to that assessment year or any other assessment year.

Illustration 10

Mr. Dutta received voluntary retirement compensation of Rs.7,00,000 after 30 years 4 months of service. He still has 6 years of service left. At the time of voluntary retirement, he was drawing basic salary Rs.20,000 p.m.; Dearness allowance (which forms part of pay) Rs.5,000 p.m. Compute his taxable voluntary retirement compensation, assuming that he does not claim any relief under section 89.

Solution

Voluntary retirement compensation received	Rs.7,00,000
Less: Exemption under section 10(10C) [Note 1]	Rs.5,00,000
Taxable voluntary retirement compensation	Rs.2,00,000

Note 1: Exemption is to the extent of least of the following:

(i)	Compensation actually received	= Rs.7,00,000
(ii)	Statutory limit	= Rs.5,00,000
(iii)	Last drawn salary × 3 × completed years of service	
	= (20,000+5,000) × 3 × 30 years	= Rs.22,50,000
(iv)	Last drawn salary × remaining months of service	
	= (20,000+5,000) × 6 × 12 months	= Rs.18,00,000

(22) Income-tax paid by employer [Section 10(10CC)] – This clause provides for exemption in the hands of an employee, being an individual deriving income by way of perquisites, not provided by way of monetary payment within the meaning of section 17(2). This applies where the tax on such income is actually paid by the employer, at the option of the employer, on behalf of such employee, notwithstanding anything contained in section 200 of the Companies Act, 1956.

This provision will provide relief to the employee if the employer is willing to bear the tax burden in respect non-monetary perquisites provided by it to the employee as otherwise the tax so paid by employer would have been treated as income of the employee.

(23) Receipts from LIC [Section 10(10D)] - This clause clarifies that any sum received under a Life Insurance Policy, including the sum allocated by way of bonus on such policy shall not be included in the total income of a person.

Recently, policies were introduced in respect of which the premium payable was very high. Sometimes, such premium was payable on a one-time basis. They are similar to deposits or bonds. With a view to ensure that such insurance policies are treated at par with other investment schemes, clause 10D has been rationalised as follows -

3.28 Income Tax

(i) Any sum received, under an insurance policy issued on or after 1.4.03 in respect of which the premium payable/paid during any of the years during the term of the policy exceeds twenty per cent of the actual capital sum assured, shall not be exempt. Therefore, sum received in respect of such policies issued prior to 1.4.03 will continue to enjoy exemption.

(ii) However, such sum received under such policy on the death of a person shall continue to be exempt.

(iii) For the purpose of calculating the actual capital sum assured under this clause,

(a) the value of any premiums agreed to be returned or

(b) the value of any benefit by way of bonus or otherwise, over and above the sum actually assured,

shall not be taken into account. Such premium or bonus may be received either by the policy holder or by any other person.

(iv) Any sum received under section 80DD(3) shall not be exempt under this clause in addition to sum received under 80DDA(3) or under a Keyman insurance policy.

(24) Payment from provident funds [Sections 10(11) and (12)] - The following payments received by an assessee will be fully exempt from tax:

(a) Provident Fund (PF) to which Provident Fund Act, 1925, applies; or

(b) Public Provident Fund.

(c) Accumulated balance payable to an employee participating in a RPF (subject to certain conditions).

The conditions for the purpose of RPF above are as follows:

(i) The employee should have rendered continuous service with the employer from whom the amount is received for a period of at least five years; or

(ii) Where the employee had not rendered such continuous service the reason for the termination of his service should have been his ill-health or contraction or discontinuance of employer's business or any other cause beyond the control of the employee.

If such conditions are not satisfied the payments become taxable in the hands of the employee.

(25) Payment from superannuation funds [Section 10(13)] - Any payment received by any employee from an approved superannuation fund shall be entirely excluded from his total income if the payment is made

(a) on the death of a beneficiary;

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

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

(d) by way of contribution to an employee on his leaving the service in connection with which the fund is established otherwise than by retirement at or after a specified age or his becoming incapacitated prior to such retirement.

In the case of (d) above the amount of exemption will be to the extent the payment made does not exceed the contribution made prior to 1-4-1962 and the interest thereon.

(26) House rent allowance (HRA) [Section 10(13A)] – HRA is a special allowance specifically granted to an employee by his employer towards payment of rent for residence of the employee. HRA granted to an employee is exempt to the extent of least of the following :

Metro Cities (i.e. Delhi, Kolkata, Mumbai, Chennai)	Other Cities
1) HRA actually received.	1) HRA actually received
2) Rent paid-10% of salary for the relevant period	2) Rent paid - 10% of salary for the relevant period
3) 50% of salary for the relevant period	3) 40% of salary for the relevant period

Note:

1. Exemption is not available to an assessee who lives in his own house, or in a house for which he has not incurred the expenditure of rent.

2. Salary for this purpose means basic salary, dearness allowance, if provided in terms of employment and commission as a fixed percentage of turnover.

3. Relevant period means the period during which the said accommodation was occupied by the assessee during the previous year.

Illustration 11

Mr. Raj Kumar has the following receipts from his employer:

(1)	Basic pay	Rs.3,000 p.m.
(2)	Dearness allowance (D.A.)	Rs. 600 p.m.
(3)	Commission	Rs.6,000 p.a.
(4)	Motor car for personal use (expenditure met by the employer)	Rs. 500 p.m
(5)	House rent allowance	Rs. 900 p.m.

Find out the amount of HRA eligible for exemption to Mr. Raj Kumar assuming that he paid a rent of Rs.1,000 p.m. for his accommodation at Kanpur. DA forms part of salary for retirement benefits.

Solution:

HRA received	Rs. 10,800
Less: Exempt under section 10(13A) [Note 1]	Rs. 7,680
Taxable HRA	Rs . 3,120

Note 1: Exemption shall be least of the following three limits:

(a) the actual amount received (900 × 12) = Rs.10,800

(b) excess of the actual rent paid by the assessee over 10% of his salary

= Rent Paid - 10% of salary for the relevant period

= (1,000×12) - 10% of [(3,000+600) × 12]

= (12,000 - 4,320) = Rs. 7,680

(c) 40% salary as his accommodation is situated at Kanpur

= 40% of [(3,000+ 600) × 12] = Rs.17,280

Note: For the purpose of exemption under section 10(13A), salary includes dearness allowance only when the terms of employment so provide, but excludes all other allowances and perquisites.

(27) Special allowances to meet expenses relating to duties or personal expenses [Section 10(14)] - This clause provides for exemption (as per Rule 2BB) in respect of the following:

(i) Special allowances or benefit not being in the nature of a perquisite, specifically granted to meet expenses incurred wholly, necessarily and exclusively in the performance of the duties of an office or employment of profit. For the allowances under this category, there is no limit on the amount which the employee can receive from the employer, but whatever amount is received should be fully utilized for the purpose for which it was given to him.

(ii) Special allowances 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 the place where he ordinarily resides or to compensate him for the increased cost of living. For the allowances under this category, there is a limit on the amount which the employee can receive from the employer. Any amount received by the employee in excess of these specified limits will be taxable in his hands as income from salary for the year. It does not matter whether the amount which is received is actually spent or not by the employee for the purpose for which it was given to him.

Rule 2BB

The following allowances have been prescribed in Rule 2BB:

Allowances prescribed for the purposes of section 10(14)(ii)

(a) any allowance granted to meet the cost of travel on tour or on transfer (Travelling Allowance);

(b) any allowance, whether granted on tour or for the period of journey in connection with transfer, to meet the ordinary daily charges incurred by an employee on account of absence from his normal place of duty;

(c) any allowance granted to meet the expenditure incurred on conveyance in performance of duties of an office or employment of profit (Conveyance Allowance);

(d) any allowance granted to meet the expenditure incurred on a helper where such helper is engaged in the performance of the duties of an office or employment of profit (Helper Allowance);

(e) any allowance granted for encouraging the academic research and training pursuits in educational and research institutions;

(f) any allowance granted to meet the expenditure on the purchase or maintenance of uniform for wear during the performance of the duties of an office or employment of profit (Uniform Allowance).

Explanation - For the purpose of clause (a) "allowance granted to meet the cost of travel on transfer" includes any sum paid in connection with the transfer, packing and transportation of personal effects on such transfer.

Allowances prescribed for the purposes of sub-clause (ii) of section 10(14)

1. Any Special Compensatory Allowance in the nature of Special Compensatory (Hilly Areas) Allowance or High Altitude Allowance or Uncongenial Climate Allowance or Snow Bound Area Allowance or Avalanche Allowance - Rs.800 or Rs.7,000 or Rs.300 per month depending upon the specified locations.
2. Any Special Compensatory Allowance in the nature of border area allowance or remote locality allowance or difficult area allowance or disturbed area allowance -Rs.1,300 or Rs.1,100 or Rs.1,050 or Rs.750 or Rs.300 or Rs.200 per month depending upon the specified locations.
3. Special Compensatory (Tribal Areas / Schedule Areas / Agency Areas) Allowance - Rs.200 per month.
4. Any allowance granted to an employee working in any transport system to meet his personal expenditure during his duty performed in the course of running such transport from one place to another, provided that such employee is not in receipt of daily allowance – 70% of such allowance upto a maximum of Rs.6,000 per month.
5. Children Education Allowance - Rs.100 per month per child upto a maximum of two children.

6. Any allowance granted to an employee to meet the hostel expenditure on his child Rs.300 per month per child upto a maximum of two children.

7. Compensatory Field Area Allowance - Rs.1,300 per month in specified areas.

8. Compensatory Modified Field Area Allowance - Rs.500 per month in specified areas.

9. Any special allowance in the nature of counter insurgency allowance granted to the members of the armed forces operating in areas away from their permanent locations for a period of more than 30 days - Rs.1,300 per month.

   Any assessee claiming exemption in respect of allowances mentioned at serial numbers 7, 8 and 9 shall not be entitled to exemption in respect of the allowance referred to at serial number 2.

10. Any transport allowance granted to an employee (other than those referred to in Sl. No. 11 below) to meet his expenditure for the purpose of commuting between the place of his residence and the place of his duty - Rs.800 per month.

11. Any transport allowance granted to an employee who is blind or orthopaedically handicapped with disability of the lower extremities of the body, to meet his expenditure for commuting between his residence and place of duty - Rs.1,600 per month.

12. Underground Allowance of Rs.800 per month would be granted to an employee who is working in uncongenial, unnatural climate in underground coal mines. This is applicable to whole of India.

Illustration 12

Mr. Srikant has two sons. He is in receipt of children education allowance of Rs 150 p.m. for his elder son and Rs.70 p.m. for his younger son. Both his sons are going to school. He also receives the following allowances:

Transport allowance : Rs.1,000 p.m. (amount spent Rs.600 p.m.)

Tribal area allowance : Rs.500 p.m.

Compute his taxable allowances.

Solution

Taxable allowance in the hands of Mr. Srikant is computed as under -

Children Education Allowance:

Elder son	[(Rs.150 – Rs.100) p.m. × 12 months]	= Rs.600	
Younger son	[(Rs.70 – Rs.70) p.m. × 12 months]	= Nil	Rs. 600
Transport allowance	[(Rs.1,000 – Rs.800) p.m. × 12 months]		Rs.2,400
Tribal area allowance	[(Rs.500 – Rs.200)p.m. × 12 months]		Rs.3,600
		∴ Taxable allowances	**Rs.6,600**

(28) Interest income arising to certain persons [Section 10(15)]

(i) Income by way of interest, premium on redemption or other payment on notified securities, bonds, annuity certificates or other savings certificates subject to such conditions and limits as may be specified in the notification.

(ii) Interest on 7% Capital Investment Bonds and 10.1% Relief Bonds, 1993 notified by the Central Government This exemption is available to Individuals and HUFs. Such capital Investment Bonds are not specified on or after the 1.6. 2002.

(iii) Interest on NRI bonds, 1988 and NRI Bonds (Second Series), and Resurgent India Bonds, 1998 issued by the SBI arising to (i) Non Resident Indians who own such bonds, (ii) their nominees or survivors, (iii) donees who have received such bonds by way of gift from such non-residents. The interest and principal received in respect of such bonds whether on maturity or otherwise should not be taken out of India. The exemption will continue to apply even after the non-resident, after purchase of such bonds, becomes a resident in any subsequent year. However, the exemption will not apply in the previous year in which such bonds are encashed prior to their maturity. Such bonds shall not be specified on or after 1.06.2002.

(iv) Interest on securities held by the Issue Department of Central Bank of Ceylon constituted under the Ceylon Monetary Law Act, 1949.

(v) Interest payable to any bank incorporated in a country outside India and authorised to perform central banking functions in that country on any deposits made by it, with the approval of the RBI, with any scheduled bank.

(vi) Interest payable to the Nordic Investment Bank, on a loan advanced by it to a project approved by the Central Government in terms of the Memorandum of Understanding entered into by the Central Government with that Bank on 25.11.86.

(vii) Interest payable to the European Investment Bank, on a loan granted by it in pursuance of the framework agreement for financial co-operation entered into by the Central Government with the Bank on 25.11.1993.

(viii) Interest payable —

(a) by the Government or a local authority on moneys borrowed by it before 1.6.2001 or debts owed by it before 1.6.2001 to sources outside India;

(b) by an industrial undertaking in India on moneys borrowed by it before 1.6.2001 under a loan agreement entered into with any such financial institution in a foreign country as may be approved by the Central Government;

(c) by an industrial undertaking in India on moneys borrowed or debt incurred by it before 1.6.2001 in a foreign country for the purchase outside India of raw material or capital equipment or components provided that the loan or the debt is approved

by the Central Government, to the extent to which such interest does not exceed the amount of the interest calculated at the rate approved by the Government;

"Purchase of capital plant and machinery" includes the purchase of such capital plant and machinery under hire-purchase agreement or a lease agreement with an option to purchase such plant and machinery.

Exemption has also been given for payment of usance interest payable outside India by an undertaking engaged in ship-breaking business, in respect of purchase of a ship from outside India.

(d) by IFCI, IDBI, the Export-Import Bank of India and the Industrial Credit and Investment Corporation of India, NHB, SIDBI, on moneys borrowed from sources outside India before 1.6.2001 to the extent to which the interest does not exceed the amount of interest calculated at the rate approved by the Central Government having regard to the terms of the loan and its repayment;

(e) by any other financial institution or a banking company established in India on loans raised in foreign countries before 1.6.2001 under approved agreements for the purpose of advancing loans to industrial undertakings in India for importing raw materials or capital plant and machinery or other goods which the Central Government may consider necessary to import in the public interest;

(f) by an industrial undertaking in India on moneys borrowed by it in foreign currency from foreign sources under a loan agreement approved by the Central Government before 1.6.2001 having regard to the need for industrial development in India will be exempt from income-tax, to the extent to which such interest does not exceed the amount of interest calculated at the rates approved by the Central Government in this behalf, having regard to the terms of the loan and its repayment.

(g) by a scheduled bank on deposits in foreign currency held by a non-resident or a person who is not ordinarily resident, where the acceptance of such deposits by the bank is approved by the RBI. It may be noted that for the purpose of exemption under this clause, a scheduled bank does not include a co-operative bank.

(h) by an Indian public limited company being a company eligible for deduction u/s 36(1)(viii), mainly engaged in providing long-term finance for construction or purchase of residential houses in India on loans raised in foreign countries under a loan agreement approved by the Central Government before 1.6.03

(i) by public sector companies on certain specified bonds and debentures subject to the conditions which the Central Government may specify by notification, including the condition that the holder of such bonds or debentures registers his name and holding with that company;

Accordingly, the Central Government has specified tax free bonds issued by India Infrastructure Company Ltd., the interest on which would be exempt under this section.

(j) by Government of India on deposit made by an employee of the Central or State Government or a public sector company in accordance with the scheme as may be notified of the moneys due to him on account of his retirement while on superannuation or otherwise. It is significant that this scheme is not applicable to non-Government employees.

The term 'industrial undertaking' means any undertaking which is engaged in :

(i) the manufacture or processing of goods; or

(ii) the manufacture of computer software or recording of programmes on any disc, tape, perforated media or other information device; or

(iii) the business of generation or generation and distribution of electricity or any other form of power; or

(iv) the business of providing tele-communication services; or

(v) mining; or

(vi) construction of ships, or

(vii) the business of ship-breaking; or

(viii) the operation of ships or aircrafts or construction or operation of rail systems.

For the purposes of the clause, "interest" shall not include interest paid on delayed payment of loan or default if which is more than 2% p.a. over the rate of interest payable in terms of such loan. Interest would include hedging transaction charges on account of currency fluctuation.

(ix) Bhopal Gas Victims **-** Section 10(15)(v) provides exemption in respect of interest on securities held by the Welfare Commissioner, Bhopal Gas Victims, Bhopal, in the Reserve Bank's Account No. SL/DH 048. Recently, in terms of an order of the Supreme Court to finance the construction of a hospital at Bhopal to serve the victims of the gas leak, the shares of the Union Carbide Indian Ltd., have been sold. The sale consideration reserved for construction has been deposited with SBI, New Delhi. The interest on the aforesaid deposit and similar deposits which may be made in future needs to be provided income tax exemption. The scope of the above exemption has been extended to interest on deposits for the benefit of the victims of the Bhopal Gas Leak disaster. Such deposits can be held in such account with the RBI or with a public sector bank as the Central Government may notify in the Official Gazette. Such notification may have prospective or retrospective effect. However, in no case it can be effective from a period earlier than 1-4-1994.

(x) Interest on Gold Deposit Bond issued under the Gold Deposit Scheme, 1999 notified by the Central Government.

(xi) Interest on bonds, issued by –

(a) a local authority; or

(b) a State Pooled Finance Entity

and specified by the Central Government by notification in the Official Gazette.

"State Pooled Finance Entity" means such entity which is set up in accordance with the guidelines for the Pooled Finance Development Scheme notified by the Central Government in the Ministry of Urban Development.

Accordingly, the Central Government has specified the "Tax-free Pooled Finance Development Bonds" under Pooled Finance Development Fund Scheme of Government of India, interest from which would be exempt under section 10(15).

(xii) interest income received by a non-resident/not-ordinarily resident in India from a deposit made on or after 1.4.2005 in an Offshore Banking Unit referred to in section 2(u) of the SEZ Act, 2005 i.e. a branch of a bank located in a SEZ and which has obtained permission under section 23(1)(a) of the Banking Regulation Act, 1949.

(29) Payments for acquisition of aircraft [Section 10(15A)] – Any payment made by an Indian company engaged in the business of operation of aircraft to acquire an aircraft on lease from the government of a foreign State or a foreign enterprise under an agreement not being an agreement entered into between 1-4-1997 and 31-3-1999, and approved by the Central Government in this behalf will be exempt. For the purpose of this clause 'foreign enterprise' means a person who is a non-resident.

This exemption has been withdrawn in respect of all such agreements entered into on or after 1st April, 2007.

The exemption for lease payments shall continue with regard to agreements entered into before 1.4.2007. Consequently, the benefit of exemption from tax, on the tax paid will be available in respect of lease payments made in pursuance of agreements entered into on or after 1.4.2007. The effect of these amendments is that up to 31.3.2007, the consideration for lease itself is exempt from tax. With effect from 1.4.2007, the consideration for lease is taxable and if the Indian company who makes payment of such consideration undertakes to bear the tax on behalf of the lessor, then such tax shall not be considered as income and further taxed. Such tax paid by the Indian company would be exempt from further tax. This is provided in clause (6BB) of section 10.

(30) Educational scholarships [Section 10(16)] - The value of scholarship granted to meet the cost of education would be exempt from tax in the hands of the recipient irrespective of the amount or source of scholarship.

(31) Payments to MPs & MLAs [Section 10(17)] – The following incomes of Members of Parliament or State Legislatures will be exempt:

(i) Daily allowance received by any Member of Parliament or of State Legislatures or any Committee thereof.

(ii) In the case of a Member of Parliament or of any Committee thereof any allowance received under Members of Parliament (Constituency Allowance) Rules, 1986; and

(iii) Any constituency allowance received by any person by reason of his membership of any State Legislature under any Act or rules made by that State Legislature.

(32) Awards for literary, scientific and artistic works and other awards by the Government [Section 10(17A)] - Any award instituted in the public interest by the Central/State Government or any body approved by the Central Government and a reward by Central/State Government for such purposes as may be approved by the Central Government in public interest, will enjoy exemption under this clause.

(33) Pension received by recipient of gallantry awards [Section 10(18)] - Any income by way of pension received by an individual who has been awarded "Param Vir Chakra" or "Maha Vir Chakra" or "Vir Chakra" or such other gallantry award as the Central Government may, by notification in the Official Gazette, specify in this behalf.

In case of the death of the awardee, any income by way of family pension received by any member of the family of the individual shall also be exempt under this clause. The expression "family" shall have the meaning assigned to it in the Explanation to clause (5) of the said section.

(34) Family pension received by widow/children/nominated heirs of members of armed forces [Section 10(19)] – Exemption is available in respect of family pension received by the widow or children or nominated heirs, of a member of the armed forces (including para-military forces) of the Union, where the death of such member has occurred in the course of operational duties, in specified circumstances and circumstances.

(35) Annual value of palaces of former rulers [Section 10(19A)] - The annual value of any one palace in the occupation of former Rulers would be excluded from their total income provided such annual value was exempt from income-tax before the de-recognition of Rulers of Indian States and abolition of their privy purses.

(**36) Income of local authorities [Section 10(20)] –** (i) All income arising to a local authority, other than from trade or business carried on by it which accrues or arises from the supply of commodity or service under its jurisdictional area is excludible from its total income.

(ii) Exemption is available to income derived by a local authority from the supply of water or electricity even outside its juridical area.

(iii) For the purposes of this clause, "local authority" means the following:

(1) Panchayat

(2) Municipality

(3) Municipal Committee and District Board legally entitled to, or entrusted by the Government with the control or management of a Municipal or local Fund

(4) Cantonment Board

(37) Income of scientific research associations approved under section 35(1)(ii) [Section 10(21)] - This clause also provides for exemption in respect of any income of scientific research associations which are approved under section 35(1)(ii). This exemption has however, been made subject to the following conditions:

(i) It should apply its income or accumulate for application wholly and exclusively to its objects and provisions of section 11(2) and (3) would also apply in relation to such accumulation.

(ii) The association should invest or deposit its funds in the forms or modes specified in section 11(5). This condition would however not apply to -

(1) any assets held by the research association where such assets form part of the corpus of the fund of the association as on 1-6-1993;

(2) any debentures of a company acquired by the association before 1-3-1983;

(3) any bonus shares coming as an accretion to the corpus mentioned above;

(4) voluntary contributions in the form of jewellery, furniture or any article notified.

(iii) The exemption will not apply to income of such association which are in the nature of profits and gains of business unless the business is incidental to the attainment of its objectives and separate books of account are maintained in respect of such business.

(iv) However, approval once granted may be withdrawn if at any time the Government is satisfied that –

(1) the scientific research association has not applied its income in accordance with sections 11(2) and (3);

(2) the scientific research association has not invested or deposited its funds in accordance with section 11(5).

Such withdrawal shall be made after giving reasonable opportunity to the assessee. A copy of the order shall be sent to the Assessing Officer as well as the assessee.

(38) Income of news agency [Section 10(22B)] – (i) This clause provides income-tax exemption on any income of such news agency set up in India solely for collection and distribution of news as specified by the Central Government.

(ii) However, in order to get this exemption, the news agency should:

(a) apply its income or accumulate it for application solely for collection and distribution of news.

(b) It should not also distribute its income in any manner to its members.

(iii) Any notification issued by the Central Government under this clause will have effect for 3 assessment years. It may include an assessment year or years commencing before the date of notification.

(iv) However, once the notification has been issued, the notification may be rescinded approval if at any time the Government is satisfied that the news agency has not applied or accumulated or distributed its income in accordance with the provisions of this section.

(v) The notification may be rescinded after giving reasonable opportunity to the assessee. A copy of the order shall be sent to the Assessing Officer as well as the assessee.

(39) Income of professional associations [Section 10(23A)] – (i) Associations or institutions of the following classes approved by the Government and applying their income or accumulating it solely to their objects shall be exempt from tax on certain items of their income. The association or institution must:

(a) be established in India;

(b) have as its object the control, supervision, regulation or encouragement of the profession of law, medicine, accountancy, engineering or architecture, or any other profession specified by the Central Government.

(ii) All income arising to such an association, except the following categories of income, are exempt from inclusion in income :

(a) income under the head 'interest on securities';

(b) income under the head 'income from house property';

(c) income received for rendering any specific service; and

(d) income by way of interest or dividends derived from its investments.

(iii) However, approval once granted may be withdrawn if at any time the Government is satisfied that –

(1) the association or institution has not applied or accumulated its income in accordance with the provisions of the section;

(2) the activities of the association or institution are not being carried out in accordance with the conditions imposed on the basis of which the approval was granted.

(iv) Such withdrawal shall be made after giving reasonable opportunity to the assessee. A copy of the order shall be sent to the Assessing Officer as well as the assessee.

(40) Income of institutions established by armed forces [Section 10(23AA)] - Any income received by any person on behalf of any regimental fund or non-public fund established by the armed forces of the Union for the welfare of the past and present members of such forces or their dependents is exempt from tax.

Students may note that donations to such institutions will qualify for deduction under section 80G.

(41) Income of Funds established for welfare of employees of which such employees are members [Section 10(23AAA)] - A number of funds have been established for the welfare of employees or their dependents in which such employees themselves are members.

3.40 Income Tax

These funds are utilised to provide cash benefits to a member on his superannuation, or in the event of his illness or illness of any member of his family, or to the dependents of a member on his death.

Example : XYZ Ltd. has an employee welfare fund. Employees, who are members of the fund, contribute a portion of their salary to the fund. The company makes an annual contribution equal to the employees' contribution. The funds thus made available are utilised by the fund to provide benefits to the members or their dependents in case of illness etc. The surplus fund may be invested in bonds, Government securities or deposited with banks. Essentially, these funds are in the nature of mutual benefit funds. Hence, their income does not qualify for exemption under section 10(23C)(iv). Since they are not charitable institutions they cannot also claim exemption under section 11 in respect of their income. They are now entitled for exemption under section 10(23AAA).

The exemption will be available only if the following conditions are fulfilled :

(i) the fund should have been established for the welfare of employees or their dependents and for such purposes as may be notified by the Board;

(ii) such employees should be the members of the fund;

(iii) the fund should apply its income, or accumulate it for application, wholly and exclusively to the objects for which it is established;

(iv) the fund shall invest its fund and contributions made by the employees and other sums received by it in any one mode specified under section 11(5);

(v) the fund should be approved by the Commissioner in accordance with the prescribed rules. The approval shall have effect for such assessment year or years not exceeding three assessment years as may be specified in the order of approval.

Note:

1. There are no conditions regarding accumulation towards the object of the fund.
2. There is no requirement of application of any minimum percentage of the income towards the object of the fund.
3. No time limit has been prescribed within which the fund must exercise the option of accumulation.
4. Any contribution made by an employer to this approved welfare fund would also not be allowed as a deduction.

(42) Income of Fund set up by Life Insurance Corporation under pension scheme [Section 10(23AAB)] - Any income of a fund set up by the LIC of India or any other insurer under a pension scheme to which contribution is made by any person for receiving pensions from such fund. Such scheme should be approved by the Controller of Insurance or the IRDA.

(43) Income of institution established for development of Khadi and Village Industries [Section 10(23B)] – (i) The exemption will be available to institutions constituted as public charitable trusts or registered under the Societies Registration Act, 1860 or under any law corresponding to that Act in force in any part of India existing solely for development of khadi and village industries.

(ii) Income derived by such institutions from the production, sale or marketing of Khadi products or village industries would be exempt for income-tax.

(iii) The conditions for availing exemption are:

(1) The institution has to apply its income or accumulate it for application, solely for the development of village industries.

(2) They should be approved by the Khadi and Village Industries Commission.

(3) Such approval is granted for a period of 3 years at a time.

(iv) However, approval once granted may be withdrawn if at any time the Government is satisfied that –

(1) the institution has not applied or accumulated its income in accordance with the provisions of the section;

(2) the activities of the institution are not being carried out in accordance with the conditions imposed on the basis of which the approval was granted.

(v) Such withdrawal shall be made after giving reasonable opportunity to the assessee. A copy of the order shall be sent to the Assessing Officer as well as the assessee.

(44) Income of authorities set up under State or Provincial Act for promotion of Khadi and Village Industries [Section 10(23BB)] - Income derived by authorities similar to Khadi and Village Industries Commission, set up under any State or Provincial Act, for the development of Khadi or Village industries in the state is exempt from tax.

(45) Income of authorities set up to administer religious or charitable trusts [Section 10(23BBA) – (i) Income of bodies or authorities established, constituted or appointed under any enactment for the administration of public, religious or charitable trust or endowments (including maths, temples, gurudwaras, wakfs, churches, synagogues, agiaries or other places of public religious worship) or societies for religious or charitable purpose is exempt from tax.

(ii) However, exemption will apply to the income of the administrative bodies or authorities but shall not apply to the income of any such trust, endowment or society mentioned above.

(46) Income of European Economic Community (EEC) [Section 10(23BBB)] - This clause provides exemption on any income of the EEC derived in India by way of interest, dividends or capital gains from investments made out of its funds under a scheme notified by the Government.

(47) Income derived by the SAARC Fund for Regional Projects [Section 10(23BBC)] - Any income derived by the SAARC Fund for Regional Projects which was set up by Colombo Declaration shall be exempt.

(48) Income of the ASOSAI-SECRETARIAT [Section 10(23BBD)] - Any income of the Secretariat of the Asian Organisation of the Supreme Audit Institutions will be exempt.

The exemption is available for 10 previous years relevant to assessment years beginning on 1.4.2001 and ending on 31.3. 2011 i.e., from A.Y.2001-02 to A.Y.2010-11.

(49) Income of the IRDA [Section 10(23BBE)] - Any income of the IRDA established under section 3(1) of the IRDA Act, 1999 will be exempt.

(50) Exemption of income of North-Eastern Development Finance Corporation Limited [Section 10(23BBF)]

(i) This section provides for exemption of any income of the North-Eastern Development Finance Corporation Limited, being a company formed and registered under the Companies Act, 1956.

(ii) The exemption has been phased out beginning with inclusion of 20% of the total income for tax for the assessment year 2006-07, 40% for the assessment year 2007-08, 60% for the assessment year 2008-09, 80% for the assessment year 2009-10 and 100% from the assessment year 2010-11. The exemption under this clause shall be fully phased out in assessment year 2010-11 and no exemption would be available from such assessment year.

(51) Exemption of income of Central Electricity Regulatory Commission [Section 10(23BBG)]

This section provides exemption to any income of Central Electricity Regulatory Commission constituted under sub-section (1) of Section 76 of the Electricity Act, 2003.

(52) Income of certain funds or institutions [Section 10(23C)] - An exemption is available in respect of any income received by any person on behalf of the following entities:

(i) the Prime Minister's National Relief Fund [Sub-clause (i)];

(ii) the Prime Minister's Fund (Promotion of Folk Art) [Sub-clause (ii)];

(iii) the Prime Minister's Aid to Students Fund [Sub-clause (iii)];

(iv) the National Foundation for Communal Harmony [Sub-clause (iiia)];

(v) any other Fund or Institution for charitable purposes approved by the prescribed authority having regard to the objects of the fund or institution and its importance throughout India or throughout any State or States [Sub-clause (iv)];

(vi) any trust (including any other legal obligation) or institution wholly for public religious or

public religious and charitable purposes approved by the prescribed authority [Sub-clause (v)];

(vii) any university or other educational institution wholly or substantially financed by the Government which exists solely for educational purposes and not for profit [Sub-clause (iiiab)];

(viii) any university or other educational institution existing solely for educational purposes and not for profit and its aggregate annual receipts do not exceed Rs. 1 crore [Sub-clause (iiiad)];

(ix) any hospital or other institution wholly or substantially financed by the Government, which exists solely for philanthropic purposes and not for profit and which exists for the reception and treatment of persons suffering from illness or mental defectiveness or treatment of convalescing persons or persons requiring medical attention [Sub-clause (iiiac)];

(x) any hospital or other institution as described in (ix) above if its aggregate annual receipts do not exceed the prescribed limit of Rs.1 crore [Sub-clause (iiiae)];

(xi) any other university or educational institutions approved by prescribed authority [Sub-clause (vi)];

(xii) any other hospital, etc. approved by prescribed authority [Sub-clause (via)].

Note:

1. The application form for such exemption will have to be made in the prescribed form and manner.

2. The prescribed authority, is empowered to call for such documents or information as it considers necessary in order to satisfy itself about the genuineness of the activities of the fund or trust or institution or any university or other educational institution or any hospital or other medical institution, before approving the same under section 10(23C)(iv), (v), (vi) or (via). Such documents may include audited annual accounts. The prescribed authority may also make such inquiries as it may deem necessary for this purpose.

3. Exemption under section 10(23C)(iv) or (v) would apply only if the funds are invested or deposited for any period during the relevant previous year otherwise in the modes specified in Section 11(5). This requirement will not however apply where the investment is maintained in the form of jewellery, furniture or any other article notified by the Board. For this purpose, the fund or trust or institution must fulfill the following conditions:

   (a) It should apply its income or accumulate it for application wholly and exclusively to the objects for which it is established,

   (b) In case where more than 15% of its income is accumulated on or after 1.4.2002, the period of accumulation of the amount exceeding 15% of its income shall be maximum 5 years.

(c) It should invest or deposit the following kinds of funds:

- any assets which form part of the corpus of the fund, trust or institution as on 1.6.1973;
- any equity shares of a public company held by any University or other educational institution or any hospital or other medical institution where such assets form part of its corpus as on 1.6.1998;
- any debentures, issued by or on behalf of any company or corporation, acquired by the fund, trust or institution, etc. before 1.3.1983;
- any bonus shares allotted to the fund, trust or institution, etc. in respect of the shares mentioned above forming part of the corpus of such fund, etc.
- any voluntary contributions received and maintained in the form of jewellery, furniture or other article as the Board may specify for any period during the previous year. However, such assets should not be in the forms or modes of investment laid down in section 11(5).

4. Investments or deposits made before 1.4.1989 in any mode or form not specified in Section 11(5) should be liquidated and invested in such modes, by 30.3.1993.

5. In case of (xi) and (xii) above, if any funds of such institution or hospital are invested before 1-6-1998 in any mode other than that specified in section 11(5), the exemption to such an institution shall not be denied if such funds do not continue to be so invested or deposited after 30.3.2001.

6. Exemption under sub-clause (iv) or (v) (vi) or (via) would be available only if the funds are invested in mode specified in section 11(5), within 1 year from the end of the previous year in which the asset is acquired or 31.3.1992, whichever is earlier.

7. Exemption under section 10(23C)(iv) or (v) or (vi) or (via) would not apply to profits and gains of business in all cases. However, where the business is incidental to the attainment of its objectives and separate books of account are maintained in respect of the business, the exemption would apply to such business profits also.

8. Notification issued under sub-clauses (iv) and (v) before 13.7.2006, being the date on which the Taxation Laws (Amendment) Act, 2006 received the assent of the President, shall have effect for a maximum 3 assessment years at any one time. Any notification issued by the Central Government [under sub-clauses (iv) or (v)] on or after 13.7.2006 will be valid until withdrawn and there will be no requirement on the part of the assessee to seek renewal of the same after 3 years.

9. In order to expedite disposal of such applications, it has now been provided that where such an application is made on or after 13.7.2006, every notification under sub-clause (iv) or sub-clause (v) shall be issued or approval under sub-clause (vi) or sub-clause (via) shall be granted or an order rejecting the application shall be passed within the period of

12 months from the end of the month in which such application was received.

10. If the total income of any entity referred to in sub-clauses (iv), (v), (vi) and (via) of section 10(23C), without giving effect to the provisions of the said sub-clauses, exceeds the basic exemption limit in any previous year, it shall –

    (1) get its accounts audited in respect of that year by a chartered accountant; and

    (2) furnish such audit report along with the return of income for the relevant assessment year. The report must be in the prescribed form, duly signed and verified by the accountant, and must contain such particulars as may be prescribed.

11. In case of donations received between 26.1.2001and 30.9.2001 for the purpose of providing relief to victims of the Gujarat earthquake, any amount unutilized or mis-utilized and not transferred to the Prime Minister's National Relief Fund on or before 31.3.2004 shall be deemed to be the income of the previous year, chargeable to tax. Further, exemption will not be available if such fund/institution does not render accounts of income and expenditure to authority prescribed under section 80G(5C)(v) as prescribed.

12. Where the fund / trust / institution / university / hospital etc. does not apply its income during the year of receipt and accumulates it, and subsequently makes a payment or credit out of such accumulated income, to any institution or trust registered u/s 12AA or to any fund / trust / institution / university / hospital, such payment or credit shall not be considered to be an application of income for its specified objectives.

13. The Central Government, or prescribed authority shall have the power to withdraw the approval or rescind the notification if :

    (i) such fund/institution/university/hospital etc. has not applied its income or invested/deposited its funds in accordance with the provisions. or

    (ii) the activities of such fund, etc are not genuine; or

    (iii) such activities are not being carried out in accordance with the conditions based upon which it was notified or approved.

    However, the approval or notification can be withdrawn or rescinded only after issuing a show cause notice and giving reasonable opportunity to such fund, etc. of being heard. After withdrawing the approval or rescinding the notification, a copy of the order is to be forwarded to the concerned fund/institution, etc. as well as to the Assessing Officer.

14. The time limit for making an application for grant of exemption or continuation thereof under section 10(23C) by a fund or trust or institution or any university or other educational institution or any hospital or other medical institution referred to in sub-clauses (iv)/(v)/(vi)/(via) of section 10(23C) has been specified in respect of such applications made on or after 1.6.2006. Such applications have to be filed *on or*

before 30th September of the succeeding financial year.

For example, if an educational institution seeks exemption under clause (vi) for P.Y.2009-10 (i.e. A.Y.2010-11), it has to make an application for grant of exemption by 30.9.2010.

15. However, any anonymous donation referred to in section 115BBC on which tax is payable in accordance with the provisions of the said section shall be included in the total income.

16. It has also been provided that all pending applications in respect of which no notification has been issued under the said sub-clause (iv) or (v) before 1st June, 2007, shall stand transferred on that day to the pre9scribed authority and the prescribed authority may proceed with such applications from the stage at which they were on that day.

(53) Income of Mutual Fund [Section 10(23D)] – (i) The income of a Mutual Fund set up by a public sector bank / public financial institution / SEBI / RBI subject to certain conditions is exempt.

(ii) "Public sector bank" means SBI or any nationalised bank *or a bank included in the category "other public sector banks" by the RBI, for example, IDBI Bank.*

Note:

1. The income of a mutual fund registered under the SEBI will be exempt without any conditions laid down by the Central Government

2. In the case of other mutual funds the condition will be applicable.

(54) Income of Investor Protection Funds [Section 10(23EA)] – (i) Clause (23EA) excludes any income by way of contributions received from recognized stock exchanges and the members thereof, from the total income of an Investor Protection Fund set up by recognised stock exchanges in India, either jointly or separately, and notified by the Central Government in this behalf.

(ii) Where any amount standing to the credit of the Fund and not charged to income-tax during any previous year is shared, either wholly or in part, with a recognised stock exchange, the whole of the amount so shared shall be deemed to be the income of the previous year in which such amount is so shared and shall accordingly be chargeable to income-tax.

(55) Exemption of specified income of Investor Protection Fund set up by commodity exchanges [Section 10(23EC)]

(i) This clause exempts income, by way of contributions received from commodity exchanges and the members thereof, of such Investor Protection Fund set up by commodity exchanges in India, either jointly or separately, as the Central Government may, by notification in the Official Gazette, specify in this behalf.

(ii) Where any amount standing to the credit of the said Fund and not charged to income-tax during any previous year is shared, either wholly or in part, with a commodity exchange, the entire amount so shared shall be deemed to be the income of the previous year in which the amount is so shared and shall accordingly be chargeable to income-tax.

(iii) A "commodity exchange" means a "registered association" as defined in clause section 2(jj) of the Forward Contracts (Regulation) Act, 1952. i.e. an association to which for the time being a certificate of registration has been granted by the Forward Markets Commission under section 14B of that Act.

(56) Income of Venture Capital Company / Fund [Section 10(23FB)] - This clause exempts any income of a venture capital company or venture capital fund set up to raise funds for investment in a venture capital undertaking. In order to obtain the exemption, the venture capital company or venture capital fund will require a certificate of registration by SEBI. Further, they should fulfill the conditions specified by the Central Government and SEBI.

It is clarified that the income of a venture capital company or venture capital fund shall continue to be exempt if the shares of the venture capital undertaking, in which the venture capital company or venture capital fund has made the initial investment, are subsequently listed in a recognized stock exchange in India.

This clause restricts such exemption only in respect of income of a venture capital company or venture capital fund from investment in a venture capital undertaking engaged in certain specified businesses or industries.

For this purpose, a venture capital undertaking has been defined to mean such domestic company whose shares are not listed in a recognised stock exchange in India and which is engaged in –

(i) the business of -

(A) nanotechnology;

(B) information technology relating to hardware and software development;

(C) seed research and development;

(D) bio-technology;

(E) research and development of new chemical entities in the pharmaceutical sector;

(F) production of bio-fuels,

(G) building and operating composite hotel-cum-convention centre with seating capacity of more than three thousand; or

(H) developing or operating and maintaining or developing, operating and maintaining any infrastructure facility as defined in the Explanation to clause (i) of sub-section (4) of section 80-IA i.e.

(1) a road including toll road, a bridge or a rail system;

(2) a highway project including housing or other activities being an integral part of the highway project;

(3) a water supply project, water treatment system, irrigation project, sanitation and sewerage system or solid waste management system;

(4) a port, airport, inland waterway, inland port or navigational channel in the sea.

(ii) dairy or poultry industry.

Therefore, exemption under this clause would be available only if the venture capital company/venture capital fund invests in the businesses or industries specified above. In such cases, tax would be payable by the investor under section 115U. If the venture capital company/venture capital fund invests in other businesses or industries, then it would not be eligible for exemption under this clause.

(57) Income of trade unions [Section 10(24)] - Any income under the heads "income from house property" and "income from other sources" of a registered trade union, within the meaning of the Trade Unions Act, 1926, formed primarily for the purpose of regulating the relations between workmen and the employers or between workmen and workmen will be exempt. Further, this exemption is also available in respect of an association of such registered unions.

(58) Income of provident funds, superannuation funds, gratuity funds [Section 10(25)] - Income of a recognized provident fund (RPF) and of an approved superannuation fund or gratuity fund is exempt from tax and the trustees of these funds would not be liable to tax thereon.

The exemption also applies to

(i) the interest on securities which are held by or are the property of statutory provident fund (SPF) governed by the Provident Funds Act, 1925;

(ii) the capital gains, if any arising to it from the sale, exchange or transfer of such securities;

(iii) any income received by the Board of Trustees constituted under Coal Mines Provident Fund and Miscellaneous Provisions Act, 1984 and under the Employees Provident Funds and Miscellaneous Provisions Act, 1952, on behalf of the Deposit Linked Insurance Funds established under these respective Acts.

(59) Income tax exemption to Employees State Insurance (ESI) Fund [Section 10(25A)] - The contributions paid under ESI Act, 1948 and all other moneys received on behalf of the ESI Corporation are paid into a Fund called the ESI Fund. This Fund is held and administered by the ESI Corporation. The amounts lying in the Fund are to be expended for payment of cash benefits and provision of medical treatment and attendance to insured persons and their families, establishment and maintenance of hospitals and dispensaries, etc.

Any income of the ESI Fund is exempted.

(60) Income of member of a scheduled tribe [Section 10(26)] - A member of a Scheduled Tribe residing in

(i) any area (specified in the Constitution) or

(ii) in the States of Manipur, Tripura, Arunachal Pradesh, Mizoram and Nagaland, or

(iii) in the Ladakh region of the state of Jammu and Kashmir

is exempt from tax on his income arising or accruing -

(a) from any source in the areas or States aforesaid.

(b) by way of dividend or interest on securities.

(61) Exemption of income of a Sikkimese Individual [Section 10(26AAA)]

(i) The following income, which accrues or arises to a Sikkimese individual, would be exempt from income-tax –

(a) income from any source in the State of Sikkim; or

(b) income by way of dividend or interest on securities.

(ii) However, this exemption will not be available to a Sikkimese woman who, on or after 1st April, 2008, marries a non-Sikkimese individual.

(62) Exemption of income of an Agricultural Produce Market Committee or Board [Section 10(26AAB)]

Any income of an Agricultural Produce Market Committee or Board constituted under any law for the time being in force for the purpose of regulating the marketing of agricultural produce would be exempt.

(63) Income of a corporation etc. for the promotion of interests of members of scheduled casts or tribes or both [Section 10(26B)] - Any income of a corporation (established by a Central, State or Provincial Act) or other body, institution or association (wholly financed by Government) formed for promotion of the interests of the members of scheduled castes or tribes or backward classes or of any two or all of them is exempt from tax.

(64) Exemption of income of corporations established to protect interests of minority community [Section 10(26BB)] - Any income of a corporation established by the Central Government or any State Government for promoting the interests of the members of a minority community will be exempt from income tax. Section 80G also provides tax relief in respect of donations made to these corporations.

(65) Exemption of income of corporation established by a Central, State or Provincial Act for welfare of ex-servicemen [Section 10(26BBB)] - This clause exempts any income of a corporation established by a Central, State or Provincial Act for the welfare and economic upliftment of ex-servicemen, being citizens of India.

(66) Co-operatives for scheduled castes [Section 10(27)] - Any income of a co-operative society formed for promoting the interests of the members of either the scheduled castes or scheduled tribes will be exempted from being included in the total income of the society.

Conditions:

(a) The membership of the co-operative society should consist of only other co-operative societies formed for similar purposes, and

(b) The finances of the society shall be provided by the Government and such other societies.

(67) Incomes of certain bodies like Coffee Board, etc. [Section 10(29A)] - Under this clause, any income accruing or arising to the following bodies is exempt from tax:

(a) the Coffee Board constituted under section 4 of the Coffee Act, 1942,

(b) the Rubber Board constituted under section 4(1) of the Rubber Board Act, 1947,

(c) the Tea Board established under section 4 of the Tea Act, 1953,

(d) the Tobacco Board constituted under the Tobacco Board Act, 1975,

(e) the Marine Products Export Development Authority established under section 4 of the Marine Products Export Development Authority Act, 1972,

(f) the Agricultural and Processed Food Products Export Development Authority established under section 4 of the Agricultural and Processed Food Products Export Development Act, 1985,

(g) the Spices Board constituted under section 3(1) of the Spices Board Act, 1986,

(h) the Coir Board established under the Coir Industry Act, 1953.

(68) Tea board subsidy [Section 10(30)] - The amount of any subsidy received by any assessee engaged in the business of growing and manufacturing tea in India through or from the Tea Board will be wholly exempt from tax.

Conditions:

(a) The subsidy should have been received under any scheme for replantation or replacement of the bushes or for rejuvenation or consolidation of areas used for cultivation of tea.

(b) The assessee should furnish a certificate from the Tea Board as to the subsidy received by him during the previous year to the Assessing Officer along with his return of the relevant assessment year or with in the time extended by the Assessing Officer for the purpose.

(69) Other subsidies [Section 10(31)] - Amount of any subsidy received by an assessee engaged in the business of growing and manufacturing rubber, coffee, cardamom or other specified commodity in India from or through the Rubber Board, Coffee Board, Spices Board or any other Board in respect of any other commodity under any scheme for replantation or replacement of rubber, coffee, cardamom or other plants or for rejuvenation or consolidation of

areas used for cultivation of all such commodities will be exempt from income-tax. Condition for submission of certificate is applicable.

(70) Exemption in respect of clubbed income of minor [Section 10(32)] - In case the income of an individual (i.e. the parent) includes the income of his minor child in terms of section 64(1A), such parent shall be entitled to exemption of Rs.1,500 in respect of each minor child. However, if income of any minor so includible is less than Rs.1,500, then the entire income shall be exempt.

Illustration 13

Mr. Khanna has an income from salary of Rs.3,00,000. Details of income of his minor children are:

Minor daughter has earned an interest income from a bank : Rs.5,000

His minor son has also earned an interest income on NSC : Rs.1,000.

Compute his gross total income for the P.Y. 2009-10.

Solution

Gross Total income of Mr. Khanna for the P.Y.2009-10

Income from Salary				Rs.3,00,000
Income from other sources				
- Minor daughter's interest income from bank	5,000			
Less: Exempt under section 10(32)	(1,500)	Rs 3,500		
- Minor son's interest income on NSC	1,000			
Less: Exempt under section 10(32)	(1,000)	Nil		Rs. 3,500
Gross Total Income				Rs.3,03,500

(71) Exemption of capital gain on transfer of a unit of Unit Scheme, 1964 (US 64) [Section 10(33)] - This clause provides that any income arising from the transfer of specified units, shall be exempt from tax. Such transfer should take place on or after 1.4.2002.

(72) Exclusion of dividends referred to in Section 115-O from total income [Section 10(34)] - This clause provides that any income by way of dividends referred to in section 115-O shall be exempt.

The Explanation to this section provides that the dividend referred to in section 115-O shall not be included in the total income of the assessee, being a Developer or Entrepreneur.

(73) Exemption of income from units from the Administrator of specified undertaking / specified company / mutual fund specified in clause (23D) [Section 10(35)] - This clause provides that any income received in respect of units from the Administrator of the specified undertaking / specified company / Mutual Fund specified under clause (23D) shall be exempt. Exemption shall not apply to any income arising from transfer of such units.

(74) Exemption of long term capital gains on transfer of listed equity shares [Section 10(36)] –Any income arising from transfer of a long-term capital asset, being an eligible equity share in a company purchased on or after 1.3.2003 but before 1.3.2004, and held for a period of 12 months or more shall be exempt from tax.

"Eligible equity share" means –

(i) any equity share in a company being a constituent of BSE-500 Index of the Stock Exchange, Mumbai as on 1.3.2003 and the transactions of purchase and sale of such equity share are entered into on a recognised stock exchange in India;

(ii) any equity share in a company allotted through a public issue on or after 1.3.2003 and listed in a recognised stock exchange in India before 1.3.2004 and the transaction of sale of such share is entered into on a recognised stock exchange in India.

(75) Exemption of capital gains on compulsory acquisition of agricultural land situated within specified urban limits [Section 10(37)] – With a view to mitigate the hardship faced by the farmers whose agricultural land situated in specified urban limits has been compulsorily acquired, clause (37) has been inserted to exempt the capital gains arising to an individual or a HUF from transfer of agricultural land by way of compulsory acquisition.

Such exemption is available where the compensation or the enhanced compensation or consideration, as the case may be, is received on or after 1.4. 2004.

The exemption is available only when such land has been used for agricultural purposes during the preceding two years by such individual or a parent of his or by such HUF.

Illustration 14

Mr. Kumar has an agricultural land (costing Rs.6 lakh) in Lucknow and has been using it for agricultural purposes since 1.4.1995 till 1.8.2000 when the Government took over compulsory acquisition of this land. A compensation of Rs.10 lakh was settled. The compensation was received by Mr. Kumar on 1.7.2009. Compute the amount of capital gains taxable in the hands of Mr. Kumar.

Solution

In the given problem, compulsory acquisition of an urban agricultural land has taken place and the compensation is received after 1.4.2004. This land had also been used for at least 2 years by the assessee himself for agricultural purposes. Thus, as per section 10(37), entire capital gains arising on such compulsory acquisition will be fully exempt and nothing is taxable in the hands of Mr. Kumar in the year of receipt of compensation i.e. A.Y.2010-11.

Illustration 15

Will your answer be any different if Mr. Kumar had by his own will sold this land to his friend Mr. Sharma? Explain.

Solution

As per section 10(37), exemption is available if compulsory acquisition of urban agricultural land takes place. Since the sale is out of own will and desire, the provisions of this section are not attracted and the capital gains arising on such sale will be taxable in the hands of Mr. Kumar.

Illustration 16

Will your answer be different if Mr. Kumar had not used this land for agricultural activities? Explain.

Solution

As per section 10(37), exemption is available only when such land has been used for agricultural purposes during the preceding two years by such individual or a parent of his or by such HUF. Since the assessee has not used it for agricultural activities, the provisions of this section are not attracted and the capital gains arising on such compulsory acquisition will be taxable in the hands of Mr. Kumar.

Illustration 17

Will your answer be different if the land belonged to ABC Ltd. and not Mr. Kumar and compensation on compulsory acquisition was received by the company? Explain.

Solution

Section 10(37) exempts capital gains arising to an individual or a HUF from transfer of agricultural land by way of compulsory acquisition. Since the land belongs to ABC Ltd., a company, the provisions of this section are not attracted and the capital gains arising on such compulsory acquisition will be taxable in the hands of ABC Ltd.

(76) Exemption of long-term capital gains on sale of equity shares / units of an equity oriented fund [Section 10(38)]

(i) This clause exempts LTCG on sale of equity shares of a company or units of an equity oriented fund on or after 1.10.2004.

(ii) This exemption is available only if such transaction is chargeable to securities transaction tax.

(iii) However, such long term capital gains exempt under section 10(38) shall be taken into a account in computing the book profit and income tax payable under section 115JB.

(iv) "Equity oriented fund" means a fund –

(1) where the investible funds are invested by way of equity shares in domestic companies to the extent of more than 65% of the total proceeds of such fund; [The percentage of equity share holding of the fund should be computed with reference

to the annual average of the monthly averages of the opening and closing figures], and

(2) which has been set up under a scheme of a Mutual Fund specified under clause (23D)

The percentage of equity share holding of the fund should be computed with reference to the annual average of the monthly averages of the opening and closing figures.

Illustration 18

Mr. Basu purchased 2,000 equity shares of ABC Ltd. (a listed company) on 1.4.2008 at Rs.20 per share. He sold all the shares on 1.6.2009 at Rs.50 per share. He also had to pay securities transaction tax (STT) on the same. Explain the taxability in the hands of Mr. Basu in the year of transfer i.e. A.Y. 2010-11.

Solution

In the given problem, since the listed equity shares of ABC Ltd. are being sold after 12 months, there is a long-term capital gains (LTCG) on the sale of these shares. Also, such LTCG has arisen after 1.10.2004 and STT has also been paid on these shares. Thus, as per section 10(38), the entire LTCG arising on such sale will be fully exempt and nothing is taxable in the hands of Mr.Basu in the year of sale i.e. A.Y.2010-11.

Illustration 19

Will your answer be different if these shares were preference shares and not equity shares? Explain.

Solution

As per section 10(38), LTCG on sale of eligible equity shares of a company on or after 1.10.2004 shall be exempt. Since the shares are preference shares and not equity shares, the provisions of this section are not attracted and the capital gains arising on such sale will be taxable in the hands of Mr. Basu in the A.Y. 2010-11.

Illustration 20

Will you answer be different if these shares were not listed in a recognised stock exchange? Explain.

Solution

As per section 10(38), LTCG on sale of equity shares of a company on or after 1.10.2004 shall be exempt. However, this exemption is available only if such transaction is chargeable to securities transaction tax. Since the shares are not listed in a recognised stock exchange, STT will not be chargeable, hence the provisions of this section are not attracted and the capital gains arising on such sale will be taxable in the hands of Mr. Basu in the A.Y.2010-11.

(77) Exemption of specified income arising from any international sporting event in India [Section 10(39)]

(i) This clause exempts income of the nature and to the extent, arising from any international sporting event in India, to the person or persons notified by the Central Government in the Official Gazette.

(ii) Such international sporting event should -

(1) be approved by the international body regulating the international sport relating to such event;

(2) have participation by more than two countries;

(3) be notified by the Central Government in the Official Gazette for the purposes of this clause.

(iii) Accordingly, in exercise of the powers conferred by section 10(39), the Central Government has notified the following:

(a) the Commonwealth Games Federation, London, United Kingdom as the person,

(b) the Commonwealth Games 2010 to be held in India, as the international sporting event,

(c) the income arising to Commonwealth Games Federation from Commonwealth Games 2010 on account of Host Fee, received or receivable from the Organising Committee Commonwealth Games 2010 Delhi, India amounting to 7.3 million GBP, as the specified income, for the purposes of exemption under section 10(39).

(78) Exemption of certain grants etc. received by a subsidiary from its Indian holding company engaged in the business of generation or transmission or distribution of power [Section 10(40)]

(i) This clause exempts income of any subsidiary company by way of grant or otherwise received from an Indian company, being its holding company engaged in the business of generation or transmission or distribution of power.

(ii) The receipt of such income should be for settlement of dues in connection with reconstruction or revival of an existing business of power generation.

(iii) The exemption under this clause is available if the reconstruction or revival of any existing business of power generation is by way of transfer of such business to the Indian company notified under section 80-IA(4)(v)(a).

(79) Exemption of any income from transfer of an asset of an undertaking engaged in the business of generation or transmission or distribution of power [Section 10(41)]

(i) This clause exempts income arising from transfer of a capital asset, being an asset of an undertaking engaged in the business of generation or transmission or distribution of power.

(ii) Such transfer should be effected on or before 31st March, 2006, to an Indian company notified under section 80-IA(4)(v)(a).

(80) Exemption of specified income of certain bodies or authorities [Section 10(42)]

(i) This clause exempts income, of the nature and to the extent, arising to a body or authority, notified by the Central Government.

(ii) Such body or authority should have been established or constituted or appointed -

(a) under a treaty or an agreement entered into by the Central Government with two or more countries or a convention signed by the Central Government;

(b) not for the purposes of profit.

(81) Exemption of income received in a transaction of reverse mortgage [Section 10(43)]

The Finance Minister had, in his budget speech of Union Budget 2007-08, announced that the National Housing Bank would introduce the Reverse Mortgage scheme. This scheme is for the benefit of senior citizens, who own a residential house property. In order to supplement their existing income, they can mortgage their house property with a scheduled bank or housing finance company, in return for a lump-sum amount or for a regular monthly/quarterly/annual income. The senior citizens can continue to live in the house and receive regular income, without the botheration of having to pay back the loan.

The loan will be given up to, say, 60% of the value of residential house property mortgaged. Also, the bank/housing finance company would undertake a revaluation of the property once every 5 years. The borrower can use the loan amount for renovation and extension of residential property, family's medical and emergency expenditure etc., amongst others. However, he cannot use the amount for speculative or trading purposes.

The bank will recover the loan along with the accumulated interest by selling the house after the death of the borrower. The excess amount will be given to the legal heirs. However, before resorting to sale of the house, preference will be given to the legal heirs to repay the loan and interest and get the mortgaged property released.

This is no doubt a noteworthy social security measure for the aged. However, the tax consequences of such reverse mortgage needed clarification.

Therefore, clause (xvi) of section 47 clarifies that any transfer of a capital asset in a transaction of reverse mortgage under a scheme made and notified by the Central Government would not amount to a transfer for the purpose of capital gains.

Further, section 10(43) provides that the amount received by the senior citizen as a loan, either in lump sum or in installments, in a transaction of reverse mortgage would be exempt from income-tax.

Capital gains tax liability would be attracted only at the stage of alienation of the mortgaged property by the bank/housing finance company for the purposes of recovering the loan.

(82) Exemption of income received by any person on behalf of NPS Trust [Section 10(44)]

The New Pension System (NPS), operational since 1st January, 2004, is compulsory for all new recruits to the Central Government service from 1st January, 2004. Thereafter, it has been opened up for employees of State Government and private sector.

NPS Trust has been set-up on 27th February, 2008 as per the provisions of the Indian Trust Act, 1882 to manage the assets and funds under the NPS in the interest of the beneficiaries. The Finance (No.2) Act, 2009 has exempted the NPS Trust from the applicability of –

(i) income-tax on any income received by any person for, or on behalf of, the NPS Trust [Section 10(44)]

(ii) dividend distribution tax in respect of dividend paid to any person for, or on behalf of, the NPS Trust; and

(iii) securities transaction tax on all purchases and sales of equity and derivatives by the NPS Trust.

Further, the NPS Trust shall receive all income without any deduction of tax at source. [Section 197A (1E)].

Thus, the NPS Trust, which was set up to manage the assets and funds under the New Pension System in the interest of the beneficiaries, would enjoy a "pass-through status".

Students should carefully note that all the items under section 10 listed above are altogether exempt from taxation and they are not even includible in the total income of the person concerned.

3.3 TAX HOLIDAY FOR UNDERTAKINGS IN FREE TRADE ZONES ETC. [SECTION 10A]

Section 10A of the Income-tax Act relates to special provision in respect of newly established undertakings in free trade zones, export processing zones, electronic hardware technology parks, software technology parks or special economic zones notified by the Central Government. The section exempts the profits and gains of such undertakings derived from the export of articles or things or computer software.

(1) Assessees who are eligible to claim exemption

The benefit of exemption under this section is available to all categories of assessees who derive any profits or gains from an undertaking engaged in export of articles or things or computer software. The profits and gains derived from on-site development of computer software (including services for development of software) outside India shall be deemed to be the profits and gains derived from the export of computer software outside India.

(2) Conditions to be satisfied for claiming exemption

This section applies to any undertaking which fulfills the following conditions:

3.58 Income Tax

(i) It has begun manufacture or production (include the cutting and polishing of precious and semi-precious stones) of articles, things or computer software during the previous year relevant to the:

(a) A.Y.1981-82 or thereafter in any FTZ; or

(b) A.Y.1994-95 or thereafter in any electronic hardware technology park (EHTP) or software technology park (STP); or

(c) A.Y.2001-2002 or thereafter in any SEZ.

(ii) It is not formed by the splitting up, or reconstruction, of a business already in existence. However, this condition shall not apply to an undertaking which is formed as a result of re-establishment, reconstruction or revival of the business of any undertaking falling under section 33B.

(iii) It is not formed by the transfer of machinery or plant previously used for any purpose. For the purposes of this clause, any machinery or plant used outside India by any person other than the assessee shall not be regarded as machinery or plant previously used for any purpose, if the following conditions are fulfilled:

(a) such machinery or plant was not, at any time previous to the date of installation by the assessee, used in India;

(b) such machinery or plant is imported into India from any country outside India; and

(c) no deduction on account of depreciation in respect of such machinery or plant has been allowed or is allowable under the provisions of this Act in computing the total income of any person prior to the date of installation of the machinery or plant by the assessee.

(d) Further, where in the case of an industrial undertaking, any machinery or plant or any part thereof previously used for any purpose is transferred to a new business, and the total value of the machinery, etc. transferred does not exceed 20% of the total value of the machinery and plant used for the business.

(iv) The sale proceeds of articles, things or computer software exported out of India must be brought into India in convertible foreign exchange within six months from the end of the previous year, or such further period as the competent authority may allow. For this purpose, "competent authority" means the RBI or such other authority as is authorised for regulating payments and dealings in foreign exchange.

Further, where the sale proceeds are credited to a separate account maintained by the assessee with any bank outside India with the approval of the RBI, such sale proceeds shall be deemed to have been received in India.

(v) In order to claim deduction under this section, the assessee should furnish an audit report from a chartered accountant in Form No.56F, along with the return of income,

certifying that the deduction has been correctly claimed. However, no deduction under section 10A shall be allowed to an assessee who does not furnish a return of his income on or before the due date specified under section 139(1).

(3) Period of tax holiday

No deduction shall be available for *A.Y.2012-13* and thereafter. i.e. Deduction shall be allowed maximum *upto A.Y.2011-12*. Such profits will be exempt for a period of 10 consecutive assessment years beginning with the assessment year relevant to the previous year in which the undertaking begins to manufacture or produce such articles or things or computer software, as the case may be.

Examples:

(i) If an undertaking is set up on 1.3.2002, then exemption shall be allowed for a period of 10 years beginning from A.Y.2002-03 upto A.Y.2011-12.

(ii) If an undertaking is set up on 1.3.2003, then exemption shall be allowed for a period of maximum 9 years beginning from A.Y.2003-04 upto A.Y.2011-12.

(iii) If an undertaking is set up on 1.3.2004, then exemption shall be allowed for a period of maximum 8 years beginning from A.Y.2004-05 upto A.Y.2011-12.

(4) Exemption in case of units established in SEZ on or after 1.4.2002 - Section 10A(1A)

In case of an undertaking in any SEZ, which begins to manufacture or produce articles or things or computer software on or after 1.4.2002, the exemption shall be as follows:

(i) 100% of the profits for 5 consecutive years beginning with the first assessment year in which it begins to manufacture, and

(ii) 50% of the profits for a further 2 assessment years.

(iii) In addition to the above, exemption for the next 3 years is provided of an amount not exceeding 50% of the profit debited to profit and loss account of the previous year in respect of which the deduction is to be allowed and credited to a reserve account to be called "Special Economic Zone Re-investment Allowance Reserve Account". This Reserve is to be created and utilised in the manner laid down under section 10A(1B).

(5) Utilisation of the reserve - Section 10A(1B)

The amount credited to the reserve account is to be utilised in the following manner –

(i) for the purposes of acquiring new machinery or plant which is first put to use within 3 years from the previous year in which the reserve was created; and

(ii) until the acquisition of new machinery or plant, the amount can be utilised for the purposes of the business of the undertaking other than for distribution by way of

dividends or profits or for remittance outside India as profits or for the creation of any asset outside India.

The prescribed particulars in respect of new machinery or plant should be furnished by the assessee along with the return of income for the assessment year relevant to the previous year in which such plant or machinery was first put to use.

(6) Consequences of mis-utilisation / non-utilisation of reserve - Section 10A(1C)

If the amount credited to the reserve account has been utilised for any purpose other than those referred to under section 10A(1B), the amount so utilised shall be deemed to be the profits in the year in which the amount was so utilised. If any amount credited to the reserve account has not been utilised before the expiry of 3 years from the previous year in which the reserve was created, then the unutilised amount shall be deemed to be the profits in the year immediately following the said period of three years and shall be charged to tax accordingly.

(7) Computation of profit from exports of such undertakings – Section 10A(4)

The profit derived from export shall be the amount which bears to the profits of the business of the undertaking, the same proportion as the export turnover in respect of such articles, things or computer software bears to the total turnover of the business. i.e.

$$\text{Profits from business of the undertaking} \times \frac{\text{Export turnover of the undertaking of such articles or things or computer software}}{\text{Total turnover of the business carried on by the undertaking}}$$

Illustration 21

Big Ltd. exports articles and has furnished the following particulars for the P.Y.2009-10.

Export sales	Rs.60,00,000
Domestic sales	Rs.20,00,000
Total sales	Rs.80,00,000
Money brought to India in convertible foreign exchange	Rs.50,00,000
Profits from business	Rs.16,00,000

You are required to compute the exemption available under section 10A for the A.Y.2010-11.

Solution

The exemption available under section 10A is

$$\text{Profits from business} \times \frac{\text{Export turnover of the undertaking of such article}}{\text{Total turnover of the business}}$$

$$= \text{Rs.}16,00,000 \times \frac{\text{Rs.}50,00,000}{\text{Rs.}80,00,000} = \text{Rs.}10,00,000$$

(8) Restrictions on other tax benefits

In computing the total income of the assessee of the previous year relevant to the assessment year immediately succeeding the last of the relevant assessment year, the following provisions shall apply:

(i) In computing depreciation under section 32, the written down value (WDV) of any asset used for the business shall be computed as if the assessee had claimed and actually been allowed the deduction in respect of the relevant assessment year.

(ii) No deduction shall be allowed under section 80-IA or 80-IB.

(iii) Any unabsorbed depreciation under section 32(2) or business loss under section 72(1) or loss under the head "Capital gains" under section 74 of the undertaking shall be allowed to be carried forward and set off in the subsequent assessment years.

The provisions of 80-IA(8) and 80-IA(10) shall apply in relation to the undertaking as they apply for the purposes of the undertaking referred to in that section.

(9) Exemption allowable in case of amalgamation / demerger

Where an undertaking of an Indian company is transferred to another company under a scheme of amalgamation or demerger, the deduction shall be allowable in the hands of the amalgamated or resulting company.

However, no deduction shall be admissible under these sections to the amalgamating company or the demerged company for the previous year in which amalgamation or demerger takes place.

(10) Declaration to be furnished for non-applicability of the section

This section is optional for the assessee. The provisions of this section shall not apply for any of the relevant assessment years where the assessee before the due date under section 139(1) furnishes to the Assessing Officer a declaration in writing that the provisions of this section may not be made applicable to him.

(11) Shifting of an undertaking from FTZ / EPZ to SEZ

Where an undertaking initially located in any free trade zone or export processing zone is subsequently located in a special economic zone by reason of conversion of such zones, the period of ten consecutive assessment years shall be reckoned from the assessment year relevant to the previous year in which the undertaking began manufacture or production in such free trade zone or export processing zone, as the case may be.

(12) Definitions for the purpose of this section

(i) "Computer software" means

(a) any computer programme recorded on any disc, tape, perforated media or other information storage device; or

(b) any customized electronic data or any product or service of similar nature, as may be notified by the Board.

which is transmitted or exported from India to any place outside India by any means.

(ii) "Export turnover" means the consideration in respect of export by the undertaking of articles or things or computer software received in, or brought into India by the assessee in convertible foreign exchange in accordance with sub-section (3), but does not include freight, telecommunication charges or insurance attributable to the delivery of the articles or things or computer software outside India or expenses, if any, incurred in foreign exchange in providing the technical services outside India.

Note: New units established in SEZ on or after 1.4.2005, shall not be allowed to take the benefit of exemption under section 10A. They shall be entitled to benefit under section 10AA.

3.4 TAX HOLIDAY FOR NEWLY ESTABLISHED UNITS IN SPECIAL ECONOMIC ZONES [SECTION 10AA]

A deduction of profits and gains which are derived by an assessee being an entrepreneur from the export of articles or things or providing any service, shall be allowed from the total income of the assessee.

(1) Assessees who are eligible for exemption

Exemption is available to all categories of assessees who derive any profits or gains from an undertaking being a unit engaged in the export of articles or things or providing any service. Such assessee should be an entrepreneur referred to in section 2(j) of the SEZ Act, 2005 i.e., a person who has been granted a letter of approval by the Development Commissioner under section 15(9).

(2) Essential conditions to claim exemption

The exemption shall apply to an undertaking which fulfils the following conditions:

(i) It has begun or begins to manufacture or produce articles or things or provide any service on or after 1.4.2006 in any SEZ.

(ii) It should not be formed by splitting up or reconstruction of a business already in existence (except in circumstances provided in section 33B) or formed by transfer to a new business, of plant and machinery previously used for any purpose exceeding 20% of the total value of machinery and plant used in the business.

(iii) For this purpose, any machinery or plant which was used outside India by any person other than the assessee shall not be regarded as machinery or plant previously used for any purpose if the following conditions are fulfilled:

(a) such machinery or plant was not at any time used in India;

(b) such machinery or plant is imported into India from any country outside India; and

(c) no deduction on account of depreciation has been allowed in respect of such machinery or plant to any person earlier.

(iv) The assessee should furnish in the prescribed form [Form No. 56F], alongwith the return of income, the report of a chartered accountant certifying that the deduction has been correctly claimed.

(v) The conditions laid down in sub-section (8) (relating to inter-unit transfer) and sub-section (10) (relating to showing excess profit from such unit) of section 80IA shall, so far as may be, apply in relation to the undertaking referred to in this section as they apply for the purposes of the undertaking referred to in section 80-IA.

(3) Period for which deduction is available

The unit of an entrepreneur, which begins to manufacture or produce any article or thing or provide any service in a SEZ on or after 1.4.2006, shall be allowed a deduction of:

(i) 100% of the profits and gains derived from the export, of such articles or things or from services for a period of 5 consecutive assessment years beginning with the assessment year relevant to the previous year in which the Unit begins to manufacture or produce such articles or things or provide services, and

(ii) 50% of such profits and gains for further 5 assessment years.

(iii) A further deduction for next 5 consecutive years shall be so much of the amount not exceeding 50% of the profit as is debited to the profit and loss account of the previous year in respect of which the deduction is to be allowed and credited to a reserve account (to be called the "Special Economic Zone Re-investment Reserve Account") to be created and utilised in the manner laid down under section 10AA(2).

Example: An undertaking is set up in a SEZ and begins manufacturing on 15.10.2005. The deduction under section 10AA shall be allowed as under:

(a) 100% of profits of such undertaking from exports from A.Y.2006- 07 to A.Y.2010-11.

(b) 50% of profits of such undertaking from exports from A.Y.2011-12 to A.Y. 2015-16.

(c) 50% of profits of such undertaking from exports from A.Y.2016-17 to A.Y.2020-21 provided certain conditions are satisfied.

(4) Conditions to be satisfied for claiming deduction for further 5 years (after 10 years) [Section 10AA(2)]

Sub-section (2) provides that the deduction under (3)(iii) above shall be allowed only if the following conditions are fulfilled, namely:-

(a) the amount credited to the Special Economic Zone Re-investment Reserve Account is utilised-

(1) for the purposes of acquiring machinery or plant which is first put to use before the expiry of a period of three years following the previous year in which the reserve was created; and

(2) until the acquisition of the machinery or plant as aforesaid, for the purposes of the business of the undertaking. However, it should not be utilized for

(i) distribution by way of dividends or profits; or

(ii) for remittance outside India as profits; or

(iii) for the creation of any asset outside India;

(b) the particulars, as may be specified by the Central Board of Direct Taxes in this behalf, under section 10A(1B)(b) have been furnished by the assessee in respect of machinery or plant. Such particulars have to be furnished along with the return of income for the assessment year relevant to the previous year in which such plant or machinery was first put to use.

(5) Consequences of mis-utilisation / non-utilisation of reserve [Section 10AA(3)]

Where any amount credited to the Special Economic Zone Re-investment Reserve Account -

(a) has been utilised for any purpose other than those referred to in sub-section (2), the amount so utilized shall be deemed to be the profits in the year in which the amount was so utilised and charged to tax accordingly; or

(b) has not been utilised before the expiry of the said period of 3 years, the amount not so utilised, shall be deemed to be the profits in the year immediately following the said period of three years and be charged to tax accordingly[Sub-section (3)].

(6) Computation of profit and gains from exports of such undertakings

The profits derived from export of articles or things or services (including computer software) shall be the amount which bears to the profits of the business of the undertaking, being the unit, the same proportion as the export turnover in respect of such articles or things or computer software bears to the total turnover of the business carried on by the *undertaking*. i.e.

$$\text{Profits from business of the undertaking being the unit} \times \left(\frac{\text{Export turnover of the undertaking of such articles or things or computer software}}{\text{Total turnover of the business carried on by the undertaking}} \right)$$

(7) Section 10A not applicable for units referred to under section 2(zc) of the SEZ Act, 2005

The provisions of section 10A shall not apply to any undertaking, being a Unit referred to under section 2(zc) of the SEZ Act, 2005, which has begun or begins to manufacture or

produce articles or things or computer software during the previous year relevant to the assessment year commencing on or after the 1.4.2006 in any SEZ.

"Unit" as per section 2(zc) of the SEZ Act, 2005 means unit set up by an entrepreneur in a Special Economic Zone and includes an existing Unit, an Offshore Banking Unit and a Unit in an International Financial Services Centre, whether established before or after the commencement of this Act.

(8) Conversion of EPZ / FTZ into SEZ

Where a Unit initially located in any FTZ or EPZ is subsequently located in a SEZ by reason of conversion of such FTZ or EPZ into a SEZ, the period of 10 consecutive assessment years referred to above shall be reckoned from the assessment year relevant to the previous year in which the Unit began to manufacture, or produce or process such articles or things or services in such FTZ or EPZ.

However, where a unit initially located in any FTZ or EPZ is subsequently located in a SEZ by reason of conversion of such FTZ or EPZ into a SEZ and has already completed the period of 10 consecutive assessment years, it shall not be eligible for further deduction from income w.e.f. 1.4.2006.

(9) Restriction on other tax benefits

(i) The loss referred to in section 72(1) or section 74(1)/(3), in so far as such loss relates to the business of the undertaking, being the Unit shall be allowed to be carried forward or set off.

(ii) In order to claim deduction under this section, the assessee should furnish report from a Chartered Accountant in the prescribed form along with the return of income certifying that the deduction is correct.

(iii) During the period of deduction, depreciation is deemed to have been allowed on the assets. Written down value shall accordingly be reduced.

(iv) No deduction under section 80-IA and 80-IB shall be allowed in relation to the profits and gains of the undertaking.

(v) Any unabsorbed depreciation under section 32(2) or business loss under section 72(1) or loss under the head “Capital gains” under section 74 of the undertaking, being the Unit shall be allowed to be carried forward and set off in the subsequent yeas.

(vi) Where any goods or services held for the purposes of eligible business are transferred to any other business carried on by the assessee, or where any goods held for any other business are transferred to the eligible business and, in either case, if the consideration for such transfer as recorded in the accounts of the eligible business does not correspond to the market value thereof, then the profits eligible for deduction shall be computed by adopting market value of such goods or services on the date of transfer. In

case of exceptional difficulty in this regard, the profits shall be computed by the Assessing Officer on a reasonable basis as he may deem fit. Similarly, where due to the close connection between the assessee and the other person or for any other reason, it appears to the Assessing Officer that the profits of eligible business is increased to more than the ordinary profits, the Assessing Officer shall compute the amount of profits of such eligible business on a reasonable basis for allowing the deduction.

(10) Deduction allowable in case of amalgamation and demerger

In the event of any undertaking, being the Unit which is entitled to deduction under this section, being transferred, before the expiry of the period specified in this section, to another undertaking, being the Unit in a scheme of amalgamation or demerger, -

(a) no deduction shall be admissible under this section to the amalgamating or the demerged Unit for the previous year in which the amalgamation or the demerger takes place; and

(b) the provisions of this section would apply to the amalgamated or resulting Unit, as they would have applied to the amalgamating or the demerged Unit had the amalgamation or demerger had not taken place.

3.5 TAX HOLIDAY FOR 100% EXPORT ORIENTED UNDERTAKINGS [SECTION 10B]

The section exempts the profits and gains of an undertaking derived from the export of articles or things or computer software.

Such profits will be exempt for a period of 10 consecutive assessment years beginning with the assessment year relevant to the previous year in which the undertaking begins to manufacture or produce such articles or things or computer software, as the case may be.

However, no deduction under this section would be available to any undertaking for *assessment year 2012-13* and subsequent years.

(1) Conditions for claiming exemption

(i) The sale proceeds of articles, things or computer software exported out of India must be brought into India in convertible foreign exchange within six months from the end of the previous year, or such further period as the competent authority may allow. For this purpose, "competent authority" means the Reserve Bank of India or such other authority as is authorised for regulating payments and dealings in foreign exchange.

(ii) Further, where the sale proceeds are credited to a separate account maintained by the assessee with any bank outside India with the approval of the RBI, such sale proceeds shall be deemed to have been received in India.

(iii) The assessee should furnish an audit report in Form 56G from a chartered accountant, etc. in the prescribed form along with the return of income, certifying that the deduction has been correctly claimed.

(iv) No deduction under this section shall be allowed to an assessee who does not furnish a return of his income on or before the due date specified under section 139(1).

(2) Computation of profit

The profit derived from export shall be the amount which bears to the profits of the business of the undertaking, the same proportion as the export turnover in respect of such articles, things or computer software bears to the total turnover of the business.

$$\text{Profits from business of the undertaking} \times \frac{\text{Export turnover of the undertaking of such articles or things or computer software}}{\text{Total turnover of the business carried on by the undertaking}}$$

For this purpose, the profits and gains derived from on-site development of computer software (including services for development of software) outside India shall be deemed to be the profits and gains derived from the export of computer software outside India.

For the purpose of this section, "manufacture or produce" shall include the cutting and polishing of precious and semi-precious stones.

(3) Restriction on other tax benefits

In computing the total income of the assessee of the previous year relevant to the assessment year immediately succeeding the last of the relevant assessment year, the following provisions shall apply:

(i) In computing depreciation under section 32, the written down value (WDV) of any asset used for the business shall be computed as if the assessee had claimed and actually been allowed the deduction in respect of the relevant assessment year.

(ii) No deduction shall be allowed under section 80-IA or 80-IB.

(iii) Any unabsorbed depreciation under section 32(2) or business loss under section 72(1) or loss under the head "Capital gains" under section 74 of the undertaking shall be allowed to be carried forward and set off in the subsequent assessment years.

The provisions of 80-IA(8) and 80-IA(10) shall apply in relation to the undertaking as they apply for the purposes of the undertaking referred to in that section.

(4) Exemption allowable in case of amalgamation or demerger

(i) Sub-section (7A) provides that where an undertaking of an Indian company is transferred to another company under a scheme of amalgamation or demerger, the deduction shall be allowable in the hands of the amalgamated or resulting company, as the case may be, for the unexpired period.

(ii) However, no deduction shall be admissible under these sections to the amalgamating company or the demerged company for the previous year in which amalgamation or demerger

takes place.

(5) Definitions for the purpose of this section

(i) "Computer software" means

(a) any computer programme recorded on any disc, tape perforated media or other information storage device; or

(b) any customized electronic data or any product or service of similar nature, as may be notified by the Board.

which is transmitted or exported from India to any place outside India by any means.

(ii) "Convertible foreign exchange" means foreign exchange which is for the time being treated by the Reserve Bank of India as convertible foreign exchange for the purposes of the Foreign Exchange Regulation Act, 1973 and any rules made there under or any other corresponding law for the time being in force.

(iii) "Export turnover" means the consideration in respect of export by the undertaking of articles or things or computer software received in, or brought into India by the assessee in convertible foreign exchange in accordance with sub-section (3), but does not include freight, telecommunication charges or insurance attributable to the delivery of the articles or things or computer software outside India or expenses, if any, incurred in foreign exchange in providing the technical services outside India.

(iv) "Hundred percent export oriented undertaking" means an undertaking which has been approved as a hundred percent export oriented undertaking by the Board appointed in this behalf by the Central Government in exercise of its powers conferred by section 14 of the Industries (Development and Regulation) Act, 1951 and its related rules.

(v) "Relevant assessment year" means any assessment year falling within a period of ten consecutive assessment years referred to in this section.

(6) Benefit of deduction under section 10B to be available to undertakings set up in Domestic Tariff Area (DTA) subsequently approved as a 100% Export Oriented Undertaking

The following clarifications have been issued regarding the scheme of tax holiday under section 10B vide Circular No. 1/2005, dated 6.1.2005–

If an undertaking set up in Domestic Tariff Area (DTA) and deriving profit from export of articles or things or computer software manufactured or produced by it, is subsequently approved as a 100% EOU by the Board appointed by the Central Government in exercise of powers conferred under section 14 of the Industries (Development and Regulation) Act, 1951, it shall be eligible for deduction under section 10B.The deduction shall be available only from the year in which the undertaking has got the approval as a 100% EOU.

It shall be available only for remaining period of 10 consecutive assessment years, beginning with the assessment year relevant to the previous year in which the undertaking begins to manufacture or produce articles or things or computer software, as a DTA unit.

Further, in the year of approval, the deduction shall be restricted to the profits derived from exports, from and after the date of approval of the DTA unit as 100% EOU.

Moreover, the deduction to such units in any case will not be available after A.Y.2011 -12 i.e. no deduction would be available w.e.f. A.Y.2012-13.

To clarify the above position, the following illustrations are given –

Different under-takings	Year in which undertaking is set up in DTA	The year in which approval as 100% EOU is granted	P.Y. for which deduction is available under section 10B
A	2001-02	2004-05	2004-05 to 2010-11
B	1996-97	2007-08	No deduction as the 10 year time-limit expires with the P.Y. 2005-06
C	2000-01	2002-03 (in 2002-03, it acquires more than 20% old plant and machinery to start development of computer software)	No deduction as there is transfer of old plant and machinery
D	2003-04	2006-07	2006-07 to 2010-11
E	1992-93	2004-05	No deduction as the 10 year time-limit has expired before 2004-05

3.6 CHARITABLE OR RELIGIOUS TRUSTS AND INSTITUTIONS [SECTIONS 11 TO 13]

(1) General discussion on trusts

Before considering the provisions of sections 11 to 13 which govern the exemption in respect of income from property held for charitable or religious purposes, let us see briefly what exactly the term trust signifies, the types of trusts and the manner of their creation. Though this aspect of the topic does not strictly fall within the purview of Income-tax, such a general knowledge would be useful in understanding the provisions of tax laws relating to charitable trusts.

A trust is an obligation annexed to the ownership and arising out of a confidence reposed in and accepted by the owner if declared and accepted by him for the benefit of another or

of another and the owner. The person who reposes or declares the confidence is called the 'author of the trust'; the person who accepts the confidence is called the trustee; the person for whose benefit the confidence is accepted is called the 'beneficiary'; the subject matter of the trust is called the 'trust property'; the 'beneficial interest' or 'interest' of the beneficiary is his right against the trustees or owner of the trust property and the instrument, if any, by which trust is declared is called the 'instrument of trust'.

Trusts can be broadly classified into two groups - Public and Private. The distinction between a public and private trust is that, whereas in the former, the beneficiaries are the general public or a class thereof, in the latter they are specific individuals. While in the former the beneficiaries constitute a body which is incapable of ascertainment, in the latter they are persons who are ascertained or capable of being ascertained. In some cases, private trusts may enure for the benefit of the public. Some religious trust may also be in the nature of public-cum-private trust.

Private trusts are governed by the Indian Trust Act, 1882. This Act does not apply to the following:

(1) The rules of Mohammedan law as to wakf;

(2) The mutual relations of the members of undivided family as determined by any customary or personal law;

(3) Public or private religious or charitable endowments; and

(4) Trust to distribute prizes taken in war among the captors.

From the above, it will be clear that public charitable trusts are not governed by the Indian Trust Act.

There are three requirements for creation of a public trust. They are (1) a declaration of trust which is binding on the settlor, (2) setting apart definite property and depriving himself of the ownership, and (3) a statement of subjects for which the property is thereafter to be held. In the case of a private trust also, more or less similar requirements exist.

The word 'trust' as used in the context of sections 11 to 13 includes, in addition to the 'trust' as explained above, 'any other legal obligation'. This is made clear in *Explanation 1* to section 13. The words 'any other legal obligation' are wide enough to cover Muslim wakfs, Hindu endowments and dedications to deities. It would also cover a case in which the trustees of a settlement are to pay the income to other trustees who in their turn are bound to apply it for purposes which are religious or charitable.

(2) TAX EXEMPTION [SECTION 11]

(i) Subject to the provisions of sections 60 to 63, the income of a religious or charitable trust or institution, to the extent specified in the Act, is exempt from tax when certain

prescribed conditions are fulfilled. The relevant income does not even form part of the total income of the trust or institution.

(ii) Section 11 deals with the exemption of income from property held in trust or other legal obligation for religious or charitable purposes wholly or in part. Section 12 deals with exemption of income derived by such a trust from voluntary contributions. Section 12A prescribe the conditions as to registration of trust etc. Section 13 enumerates the circumstances under which the exemption available under sections 11 to 12 will be denied.

(iii) Income from property held for charitable or religious purposes - The following income shall not be included in the total income of the previous year of the person in receipt of the income:

(a) Income derived from property held under trust wholly for charitable and religious purposes to the extent such income is applied in India for such purpose.

(b) Income derived from property held under trust in part only for such purpose, to the extent such income is applied in India for such purposes. However, the trust in question must have been created before 1.4.1962.

(c) Income derived from property held under trust, created on after 1.4.1952 for charitable purpose which tends to promote international welfare in which India is interested to the extent to which such income is applied to such purpose outside India. This does not cover religious trusts.

(d) Income derived from property held under a trust for charitable or religious purposes, created before 1.4.1952, to the extent to which such income is applied for such purposes outside India.

(e) Income in the form of voluntary contributions made with a specific direction that they shall form part of the corpus of the trust or institution.

Thus, it may be noted that only such income derived from property held under trust wholly for charitable or religious purposes is exempt. If the property is held in part only for such purposes, it is necessary that such a trust must have been created before the commencement of the Act. In both the cases, the exemption is limited to the extent such income is applied in India for such specified purposes.

(iv) Types of trusts - To get exemption in respect of income applied outside India, the trusts are divided into two types:

(a) If the object of the trust is to promote international welfare in which India is interested, such trust may have been created on or after 1.4.1952.

(b) If the trust is for any other charitable purpose it must have been created before 1.4.1952. Here also, the exemption is limited to the extent to which such income is

applied outside India for such specified purposes. It is to be noted however that a direction from CBDT by a general or special order is necessary before such exemption can be claimed.

(v) Conditions for claiming exemption

(a) Property should be held under trust - The exemptions explained in the preceding paragraphs are available if and only if there is a valid trust or there is a legal obligation, under which the income derived from the property held under such trust or legal obligation is to be applied for charitable or religious purposes. If there is no trust nor any legal obligation, the income will not be exempt even if the whole of such income is applied to charitable or religious purposes. A mere creation of a trust for the income is not sufficient, there must be a trust of the property out of which the income is derived before one can consider any exemption under section 11.

(b) Income should be applied for charitable purposes - Section 2(15) states that 'charitable purpose' includes relief of the poor, education, medical relief, *preservation of environment (including watersheds, forests and wildlife) and preservation of monuments or places or objects of artistic or historic interest* and the advancement of any other object of general public utility.

The definition of "charitable purpose" includes "any other object of general public utility" The question arises as to what is an object of "general public utility". This expression has not been defined anywhere in the Act.

In *CIT v. Gujarat Maritime Board (2007) 295 ITR 561*, the Supreme Court observed that the Gujarat Maritime Board was established for the predominant purpose of development of minor ports within the State of Gujarat, the management and control of the Board was essentially with the State Government and there was no profit motive. The assessee, Gujarat Maritime Board, was under a legal obligation to apply its income which was directly and substantially from the business held under trust for the development of minor ports in Gujarat. Therefore, the Supreme Court held that the assessee was entitled to be registered as "charitable trust" under section 12A.

A number of entities functioning on commercial basis claim exemption of their income either under section 10(23C) or section 11 on the foundation that they are charitable institutions. This is based on the contention that they are engaged in the "advancement of an object of general public utility" as is included in the fourth part of the present definition of "charitable purpose". There were many decisions rendered in the past supporting the view that if unconnected business is held under a trust for promoting the object of general public utility and if profits are used for promoting such objects, income thereof shall be exempt, for example, the decision of the Supreme Court in *CIT v. Madras Stock Exchange Ltd. (1981) 130 ITR 184*. However, such a claim in respect of an activity carried out on commercial basis, goes against the basic intention of the provision.

Therefore, in order to limit the ambit of the phrase "advancement of any other object of general public utility", section 2(15) has been amended to provide that "the advancement of any other object of general public utility" would not be a charitable purpose if it involves the carrying on of –

(a) any activity in the nature of trade, commerce or business or,

(b) any activity of rendering of any service in relation to any trade, commerce or business,

for a fee or cess or any other consideration, irrespective of the nature of use or application of the income from such activity, or the retention of such income, by the concerned entity. This amendment would affect the ratio laid down in the cases cited above.

Circular No.11/2008 dated 19.12.2008

Exemption under section 11 in case of an assessee claiming both to be a charitable institution as well as a mutual organisation

The proviso to section 2(15) will apply only to entities whose purpose is advancement of any other object of general public utility i.e. the last limb of the definition of charitable purpose contained in section 2(15). Hence, such entities will not be eligible for exemption under section 11 or under section 10(23C) if they carry on commercial activities. Whether such an entity is carrying on an activity in the nature of trade, commerce or business is a question of fact which will be decided based on the nature, scope, extent and frequency of the activity.

There are industry and trade associations who claim exemption from tax under section 11 on the ground that their objects are for charitable purpose as these are covered under any other object of general public utility. Under the principle of mutuality, if trading takes place between persons who are associated together and contribute to a common fund for the financing of some venture or object and in this respect have no dealings or relations with any outside body, then any surplus returned to the persons forming such association is not chargeable to tax. In such cases, there must be complete identity between the contributors and the participants.

Therefore, where industry or trade associations claim both to be charitable institutions as well as mutual organizations and their activities are restricted to contributions from and participation of only their members, these would not fall under the purview of the proviso to section 2(15) owing to the principle of mutuality. However, if such organizations have dealings with non-members, their claim to be charitable organizations would now be governed by the additional conditions stipulated in the proviso to section 2(15).

In the final analysis, however, whether the assessee has for its object the advancement of any other object of general public utility is a question of fact. If such assessee is engaged in any activity in the nature of trade, commerce or business or renders any service in

relation to trade, commerce or business, it would not be entitled to claim that its object is charitable purpose. In such a case, the object of general public utility will be only a mask or a device to hide the true purpose which is trade, commerce or business or the rendering of any service in relation to trade, commerce or business. Each case would, therefore, be decided on its own facts and no generalization is possible.

Circular No. 395, dated 24.9.1984 - Promotion of sports and games is considered to be charitable purposes within the meaning of section 2(15). Therefore, an association or institution engaged in the promotion of games and sports can claim exemption under section 11 even if it is not approved under section 10(23).

A trust will be treated as a charitable trust under section 2(15) even if its object involves the carrying on of an activity for profit. Such a trust will not be denied exemption under section 11 on the ground that its objects are non-charitable.

(vi) Application and accumulation - We have seen that the exemption is limited to the extent to which such income is applied in India or outside India as the case may be. Is it necessary that the entire income should be so applied? The Act gives a concession here. It is possible to claim the exemption even if the trust or institution applies only 85 per cent of the income derived from the trust property for the purpose of the trust, during the relevant previous year.

An accumulation not exceeding 15 per cent of the income from such property is permissible. For computing this 15 per cent, voluntary contributions referred to in section 12 shall be deemed to be part of the income. It must be clearly noted that accumulation must be with the object of application of the accumulated amount to charitable or religious purpose in India at a later date. Such a facility for accumulation is not available for those trusts whose income is to be applied outside India.

(vii) Inability to apply in full 85 per cent of the income - It is clear from the above discussion that free accumulation not exceeding 15 per cent of income from property is permissible. Hence, the balance 85 per cent must be applied during the previous year for the purposes for which the trust has been created. However, it is possible that the trust is unable to apply the minimum of 85 per cent of its income during the previous year due to either of the following reasons.

(1) The whole or any part of the income has not been received during that year.

(2) Any other reason.

In the first class of cases, the period of application is extended to cover the previous year in which the income is actually received and the previous year immediately following the year. But the amount which may be so claimed to have been so applied during the subsequent previous year cannot exceed the amount of the income which had not been received earlier but received during a subsequent previous year.

Example 1 - During the previous year ending 31st March, 2010, a charitable trust earned an income of Rs.1,00,000 but it received only Rs.60,000 in that year. The balance of Rs.40,000 is received in the year ending 31-3-2011.

	Rs.
Total income earned during the P.Y.2009-10	1,00,000
Actual receipt in P.Y.2009-10	60,000
Permissible accumulation @15% of Rs.1,00,000	15,000
Balance to be applied during P.Y. 2009-10	45,000
Amount received in P.Y.2010-11 to be applied in P.Y.2010-11 or P.Y.2011-12	40,000

Since this amount of Rs.40,000 is received during the P.Y. 2010-11, this can be applied in the P.Y.2010-11 or in the P.Y. 2011-12. If the entire amount of Rs.40,000 is duly spent for charitable purposes in these two years, the exemption is fully available but if only part of the amount is so spent within the period, the exemption is restricted to that part only.

There may be a case where the inability springs from some other reason *e.g.* late receipt of the income making it impossible to spend it before the end of the year.

Example 2 - A trust receives a sum of Rs.50,000 on 30th March, 2010. Its previous year ends on 31-3-2010.

It is obvious that it is impossible to apply the requisite sum within one day. Therefore, it has been provided that such sum can be applied at any time during the immediately following previous year i.e. up to 31-3-2011.

(viii) Formalities: Exercise of option - To avail the facility of the extended period of application of income, the trust has to exercise an option in writing that the income applied later as prescribed may be deemed to be income applied to the relevant charitable purposes during the previous year in which the income was derived.

Such option has to be exercised before the expiry of the time allowed statutorily under section 139(1).

The income so deemed to have been applied shall not however be taken into account in calculating the amount of income applied to such purposes, during the previous year in which the income is actually received or during the immediately following previous year as the case may be. Thus, in the Example I given above, the amount of Rs.40,000, received subsequently in the year 2010-11 and applied to charitable purposes in the year 2010-11, will by virtue of the option exercised by the trust, be deemed to be applied for charitable purposes in the year 2009-10 itself. Therefore, such an amount will not be taken into consideration in determining the amount of income applied for charitable purposes in the year 2010-11.

Sub-section (1B) of section 11 provides that where the income for which an option has been exercised as discussed above, is not actually applied, it is to be treated as the income of the previous year immediately following the year of receipt or the previous year in which it was derived as the case may be.

(ix) Conditional accumulation - Apart from the provision for accumulation upto 15 per cent, a trust has also got the rights for conditional accumulation. The relevant provisions are contained in section 11(2).

Where eighty-five per cent of the income is not applied or is not deemed to have been applied to charitable or religious purposes in India but is accumulated or set apart either wholly or in part for application to such purposes in India, such income shall not be included in the total income of the previous year if the following conditions are satisfied.

(a) A notice in writing is given to the Assessing Officer in the prescribed manner specifying the purpose for accumulation and the period for which the income is to be accumulated or set apart. Such period should not exceed five years.

Any amount credited or paid, out of income which is accumulated or set apart, to any trust or institution registered under section 12AA or to any fund or institution or trust or any university or other educational institution or any hospital or other medical institution referred to in sub-clause (iv) or sub-clause (v) of sub-clause (vi) or sub-clause (via) of clause (23C) of section 10, shall not be treated as application of income for charitable or religious purposes, either during the period of accumulation or thereafter.

(b) The money so accumulated or set apart should be invested or deposited in the following modes specified in section 11(5):

(1) Investment in Government Saving Certificates.

(2) Deposits with Post Office Savings Banks.

(3) Deposit with Scheduled Banks or Co-operative Banks.

(4) Investment in units of the Unit Trust of India.

(5) Investment in Central or State Government Securities.

(6) Investments in debentures issued by or on behalf of any company or corporation. However, both the principal and interest thereon must have been guaranteed by the Central or the State Government.

(7) Investment or deposits in any public sector company.

Where an investment is made in the shares of any public sector company and such public sector company ceases to be a public sector company, the investment so made shall be deemed to be an investment made for a period of

three years from the date of such cessation and in the case of any other investment or deposit, till the date of its maturity.

(8) Investment in bonds of approved financial corporation providing long term finance for industrial development in India and eligible for deduction under section 36(1)(viii).

(9) Investment in bonds of approved public companies whose principal object is to provide long-term finance for construction or purchase of houses in India for residential purposes and eligible for deduction under section 36(1)(viii).

(10) Deposits with or investment in any bonds issued by a public company formed and registered in India with the main object of carrying on the business of providing long-term finance for urban infrastructure in India.

"Long-term finance" means any loan or advance where the terms under which moneys are loaned or advanced provide for repayment along with interest thereof during a period of not less than five years.

"Urban infrastructure" means a project for providing potable water supply, sanitation and sewerage, drainage, solid waste management, road, bridges and flyovers or urban transport.

(11) Investment in immovable property excluding plant and machinery, not being plant and machinery installed in a building for the convenient occupation thereof.

(12) Deposits with Industrial Development Bank of India.

(13) Any other mode of investment or deposit as may be prescribed. Rule 17C specifies the following other modes: (1) Investments in units issued under any scheme of mutual fund referred to in section 10(23D); (2) Any transfer of deposits to Public Account of India; (3) Deposits made with an authority constituted in India or under any law enacted either for the purpose of dealing with and satisfying the need for housing accommodation or for the purpose of planning, development or improvement of cities, towns and villages, or for both; (4) investment by way of acquiring equity shares of a 'depository'; (5) investment by a recognized Stock Exchange, in the equity shares of a company promoted by it to acquire the membership rights of other stock exchanges, where at least 51% of the paid-up share capital is held by the Stock Exchange and the balance is held by its members; (6) investment by way of acquiring equity shares of an incubatee by an incubator.

Where the income of the trust -

(a) is applied for purposes other than charitable or religious purposes; or

(b) ceases to be accumulated or set apart for application thereto; or

(c) ceases to remain invested or deposited in any modes mentioned under section 11(5) above; or

(d) is not utilised for the purpose for which it is so accumulated or set apart during the period specified (not exceeding 5 years) or in the year immediately following thereof.

However, in computing the aforesaid period of 5 years, the period during which the income could not be applied for the purposes for which it is so accumulated or set apart due to an order or injunction of any Court shall be excluded.

(e) accumulated or set apart for application to charitable and religious purposes in India, is credited or paid to any trust or institution registered under section 12AA or to any fund or institution or trust or any university or other educational institution or any hospital or other medical institution referred to in sub-clause (iv) or (v) or (vi) or (via) of clause (23C) of section 10,

such income shall be deemed to be the income of the previous year –

(a) in which it is so applied; or

(b) in which it ceases to be accumulated or set apart; or

(c) in which it ceases to remain so invested or deposited; or

(d) immediately following the expiry of the period aforesaid; or

(e) in which it is paid or credited.

It is possible that due to circumstances beyond the control of the person in receipt of the income, any income invested or deposited in approved modes cannot be applied for the purpose for which it was accumulated or set apart. In such a case, an application may be made to the Assessing Officer specifying such other purposes as are in conformity with the objects of the trust. The Assessing Officer may allow the application of income to such other purposes. If such a permission is granted by the Assessing Officer, the new purposes will be deemed to be purposes specified in the written notice given to the Assessing Officer.

It is to be noted that the Assessing Officer cannot allow transfer of any such accumulated income to other charitable trusts/institutions as application of income towards charitable purposes. This has created genuine problems for those trusts and institutions which are wound up. However, in case of a trust or institution which has invested or deposited its income in any of the forms mentioned in section 11(5), the Assessing Officer can allow application of such income for crediting or payment to any trust or institution registered under section 12AA or any fund or institution or trust or university or education institution or hospital or medical institution covered by section 10(23C). Such application can be allowed only in the year in which such trust or institution is dissolved.

(x) Cases where trust property consists of a business undertaking - Section 11(4) clarifies that for the purposes of section 11, property held under trust may consist of a business undertaking so held. If that be so, the trustees may claim that the income of such undertaking enjoys exemption under section 11. Section 11(4) provides for two things -

(1) The Assessing Officer shall have the power to determine the income of the undertaking in accordance with the provisions of the Act relating to assessment, and

(2) Where the income determined by the Assessing Officer is in excess of that shown in the books of the undertaking, such excess shall be deemed to be applied to purposes other than charitable or religious purposes and accordingly be deemed to be the income of the previous year in which it has been deemed to have been so applied.

(xi) Charitable trust engaged in business activity [Section 11(4A)] - Consequently, a charitable trust engaged in business activity will be liable to any tax on income from the activity. However, exemption would be available to the trust in respect of income earned from such business activity if –

(i) such business is incidental to the attainment of the objects of the trust/institution; and

(ii) separate books of account are maintained by such trust/institution in respect of such business.

Note – Profits derived by a trust/institution referred to in clauses (21), (23A), (23B), (23BB) and (23C) of section 10 will continue to be exempt from income-tax, since section 11(4A) does not override the provisions of section 10.

(xii) Instances where capital gains would be deemed to have been applied for charitable purposes [Section 11(1A)]

(a) Transfer of a capital asset held under trust wholly for charitable or religious purposes [Section 11(1A)(a)] - Where the whole of the net consideration from the transfer of the capital asset is utilised for acquiring a new capital asset which is held under trust wholly for charitable or religious purposes, the entire amount of capital gains arising from the transfer would be deemed to have been applied for charitable or religious purposes. If, however, only a part of the net consideration is utilised in acquiring the new capital asset, the amount of capital gains deemed to have been utilised for charitable or religious purposes shall be equal to the excess of the proceeds utilised over the cost of the asset transferred.

Example

Original cost of capital asset transferred	Rs.1,00,000
Consideration for which it is transferred	Rs.1,50,000
Situation 1 Cost of new capital asset acquired	Rs.1,50,000

Situation 2 Cost of new capital asset acquired Rs.1,20,000

Amount that will be deemed to have been applied for charitable purposes.

Situation 1 Rs.50,000

Situation 2 Rs.20,000

(b) Transfer of a capital asset held under trust in part only for charitable and religious purposes [Section 11(1A)(b)] - Where only a part of a capital asset has been transferred, only the "appropriate fraction" of the capital gain arising from the transfer shall be deemed to have been applied to charitable or religious purposes. Where the whole of the net consideration is utilised in acquiring the new capital asset, the whole of the appropriate fraction of such capital gain will be deemed to have been so applied. In any other case, the exemption will be limited to so much of the appropriate fraction of the amount utilised for acquiring the new asset as exceeds the appropriate fraction of the cost of the transferred asset.

"Appropriate fraction" means the fraction which represents the extent to which the income derived from the capital asset transferred was applicable to charitable or religious purposes before such transfer.

Example: A capital asset is being held under trust. Two-thirds of the income derived from such capital asset are being utilised for the charitable purposes of the trust. The asset is being transferred.

Cost of transferred asset Rs.1,20,000

Net consideration Rs.1,80,000

Cost of new asset acquired Rs.1,50,000

Capital gains Rs.60,000 [Rs.1,80,000 – Rs.1,20,000]

Appropriate fraction 2/3rd

Income represented by 'appropriate fraction' = 2/3rds of Rs.60,000 = Rs.40,000

Since the entire net consideration has not been utilised in acquiring the new asset, the amount deemed to have been utilised for charitable purpose will be (2/3rds of Rs.1,50,000) – (2/3rds of Rs.1,20,000) = Rs.1,00,000 – Rs.80,000 = Rs.20,000.

(xiii) Voluntary Contributions [Section 12] - Any voluntary contribution received by a trust created wholly for charitable or religious purposes or by an institution established wholly for such purposes shall for the purposes of section 11, be deemed to be income derived from property held under trust wholly for charitable or religious purposes. However, corpus donations (i.e. contributions made with a specific direction that they shall from part of the corpus of the trust or institution) shall not be treated as income. Such corpus donations are treated as capital receipts not chargeable to tax. Other voluntary

contributions would be treated as income. However, exemption can be claimed in respect of such income subject to fulfillment of the conditions mentioned below –

(i) The trust should be registered under section 12AA with the Commissioner of Income-tax;

(ii) If the total income of the trust exceeds the basic exemption limit, the accounts of the trust should be audited.

(iii) The trust should apply at least 85% of its income for the approved purposes.

(iv) The balance should be invested or deposited in specified forms or modes.

Note – It may be noted that the corpus donations are to be considered for the purpose of determining whether the accounts of the trust are to be audited. Further, corpus donations have to be invested only in the investments approved under section 11(5). If invested elsewhere, the income from unapproved investment would be chargeable to tax.

(3) CONDITIONS FOR APPLICABILITY OF SECTIONS 11 & 12 [SECTION 12A]

(i) The exemption provisions contained in section 11 and 12 as explained above shall not apply in relation to the income of any trust or institution unless the following conditions are satisfied:

(a) A charitable or religious trust or institution is required to make an application for registration in the prescribed form and in the prescribed manner to the Commissioner. The trust should be registered under section 12AA. In such cases, the exemption provisions of section 11 and 12 would apply from the date of creation of the trust or establishment of the institution [Section 12A(1)].

This requirement of filing an application for registration under section 12A within one year of creation of the religious or charitable trust or institution has been removed. The application can be filed at any time now.

Accordingly, in respect of applications filed on or after 1st June, 2007, the provisions of sections 11 and 12 shall apply from the assessment year relevant to the financial year in which the application is made i.e. the exemption would be available only with effect from the assessment year relevant to the previous year in which the application is filed. It would not be available in respect of any earlier assessment year [Section 12A(2)].

(b) **Audit -** Where the total income of the trust without giving effect to the provisions of section 11 and 12 exceeds the maximum amount which is not chargeable to income-tax in any previous year, the accounts of the trust must be audited by a chartered accountant the report of such audit in the prescribed form duly signed and verified by such accountant and setting forth such prescribed particulars, should be furnished along with the return.

(ii) Procedure for Registration [Section 12AA] - Accordingly, the Commissioner, on receipt of an application for registration of a trust or institution made under section 12A(1)

shall proceed as follows :

(a) He would call for such documents or information from the trust or institution as he thinks necessary in order to satisfy himself about the genuineness of activities of the trust or institution and may also make such enquiries as he may deem necessary in this behalf.

(b) After satisfying himself about the objects of the trust or institution and the genuineness of its activities, he shall pass an order in writing registering the trust or institution.

(c) If he is not satisfied, he shall pass an order in writing refusing to register the trust or institution.

(d) A copy of such an order issued under (b) or (c) above shall be sent to the applicant. However, an order under (c) shall not be passed unless the applicant has been given a reasonable opportunity of being heard.

(e) Every order granting or refusing registration shall be passed within six months from the end of the month in which the application for registration of trust or institution is received by the Commissioner.

(f) Where a trust or an institution has been granted registration and subsequently, if the Commissioner of Income-tax is satisfied that the activities of any trust or institution are not genuine or are not being carried out in accordance with the objects of the trust or institution, he can pass an order in writing canceling the registration granted under the said section. However, the trust or institution should be given a reasonable opportunity of being heard.

(g) Any order passed by the Commissioner of Income-tax under section 12AA refusing registration is appealable under section 253 to the Income-tax Appellate Tribunal.

(4) DENIAL OF EXEMPTION [SECTION 13]

(i) The following incomes of charitable or religious trusts and institutions would not be eligible for exemption under sections 11 and 12:

(a) Where the property is held under a trust for private religious purposes, no part of the income will be exempt if it does not enure for the benefit of the public [Section 13(1)(a)].

(b) Where a trust has been established for the benefit of any particular religious community or caste, the income thereof will not be eligible for exemption. However, a trust or institution created or established for the benefit of scheduled caste, backward classes, scheduled tribes or women and children shall not be treated as a trust or institution created or established for the benefit of a religious community or caste within the meaning of section 13(1)(b).

(c) Where the trust or the institution has been created or established after 31.3.1962, if any part of its income enures directly or indirectly for the benefit of any person referred to in section 13(3) [Section 13(1)(c)].

(d) Irrespective of the date of the creation of the trust or the establishment of the institution, if any part of its income or any property belonging to it during the relevant previous year is used or applied directly or indirectly for the benefit of any person referred to in section 13(3) [Section 13(1)(c)].

(e) Any income of a trust or institution, if –

(i) its funds are invested or deposited otherwise than in the forms or modes specified in section 11(5);

(ii) it holds shares in a company other than -

(1) a public sector company; or

(2) shares prescribed as a form or mode of investment under section 11(5)(xii).

However, these restrictions do not apply in respect of :

(i) any assets forming part of the trust as on 1-6-1973.

(ii) Any accretion to the corpus shares by way of bonus shares allotted to the trust.

(iii) debentures issued by or on behalf of any company or corporation and acquired by the trust before March 1, 1983.

(iv) any asset not covered under section 11(5), where such asset is held for not more than one year from the end of the previous year in which such asset is acquired.

(v) any funds representing the profits and gains of business, being profits and gains of any previous year relevant to the assessment year 1984-85 or any subsequent assessment year. However, such relaxation of the restriction will be denied unless the trust keeps separate accounts for the business. As already noted, subject to certain exceptions, such business profits are no longer eligible for exemption under section 11.

(ii) Prohibited use or application - We have noted above that when any part of the income or any property of the trust whenever created, is, during the previous year, used or applied directly, for the benefit of any person referred to in section 13(3), the denial of exemption operates. Section 13(2) specifies a few particular instances where the income or the property is to be deemed to have been used for the benefit of a person referred to in section 13(3). It should be noted that those particular instances do not in any way restrict the general meaning of the expression “used or applied for the benefit of a person”. The provisions of section 13(2) are as follows:

The income or the property of the trust or institution or any part of such income or property is to be deemed to have been used or applied for the benefit of a person referred to in section 13(3) in the following cases:

(a) Loan without adequate interest or adequate security - If any part of the income or the property of the trust or institution is or continues to be lent to any person referred to in section 13(3) for any period during the previous year without either adequate security or adequate interest or both.

(b) Allowing use of property without adequate rent - If any land, building or other property of the trust or institution is or continues to be, made available, for the use of

any person referred to in section 13(3) for any period during the previous year without charging adequate rent or other compensation.

(c) **Excess payment for services -** If any amount is paid out of the resources of the trust or institution to any of the persons referred to in section 13(3) for services rendered to the trust or institution but such amount is in excess of a reasonable sum payable for such services.

(d) **Inadequate remuneration for services rendered -** If the services of the trust or institution are made available to any person referred to section 13(3) without adequate remuneration or other compensation.

(e) **Excess payment for purchase of property -** If any share, security or other property is purchased by or on behalf of the trust or institution from any person referred to in section 13(3) during the previous year for a consideration which is more than adequate.

(f) **Inadequate consideration for property sold -** If any share, security or other property is sold by or on behalf of the trust or institution to any person referred to in section 13(3) during the previous year for a consideration which is less than adequate.

(g) **Diversion of income or property exceeding Rs.1,000 -** If any income or property of the trust or institution is diverted during the previous year in favour of any person referred to in section 13(3) provided the aggregate value of such income and property diverted exceeds Rs.1,000.

(h) **Investment in substantial interest concerns -** If any funds of the trust or institution are, or continue to remain, invested for any period during the previous year in any concern in which any person referred to in section 13(3) has a substantial interest.

Section 13(4) provides some respite where the aggregate of the funds invested in the said concern does not exceed five per cent of the capital of that concern. In such a case, the exemption under section 11 will be denied only in relation to such income as arises out of the said investment.

(iii) Exemption not to be denied to charitable trusts providing educational or medical facilities to specified persons [Section 13(6)]

A charitable or religious trust running an educational institution or a medical institution or a hospital shall not be denied the benefit of exemption under section 11 merely due to the reason that the benefit of educational or medical facilities have been provided to the specified persons referred to in section 13(3). However, the value of such facilities provided to such specified persons either free of cost or at a concessional rate would be deemed to be the income of the trust. Such income would not be eligible for exemption under section 11.

(iv) Anonymous donations [Section 13(7)]

The exemption provisions contained in section 11 or section 12 shall not be applicable in respect of any anonymous donation referred to in section 115BBC on which tax is payable in accordance with the provisions of that section. For example, section 11(1)(d) of the Act

provides that any income in the form of voluntary contributions made with a specific direction that they shall form part of the corpus of the trust or institution shall not be included in the total income of such trust/institution for the relevant previous year. However, if a trust or institution established wholly for charitable purposes receives an anonymous donation with a specific direction that the donation shall form part of the corpus of the trust or institution, such anonymous donation would not be exempt by virtue of section 11(1)(d). It would be taxable at 30% as provided in section 115BBC.

(v) Prohibited category of persons - Section 13(3) gives the list of persons, use or application of the income or property of a trust for whose direct or indirect benefit results in a denial of the exemption contemplated in section 11 for a charitable or religious trust or institution. The said persons are:

(1) The author of the trust or the founder of the institution.

(2) Any person who has made a substantial contribution to the trust or institution, that is, any person whose total contribution up to the end of the relevant previous year exceeds Rs.50,000.

(3) Where the author, founder or the person making a substantial contribution is a HUF, any member of the family.

(4) Any trustee of the trust or manager (by whatever name called) of the institution.

(5) Any relative of any such author, founder, person, member, trustee or manager as referred to above.

(6) Any concern in which any of the persons referred to in clauses (1) to (5) above has a substantial interest.

Relative - The expression "relative", in relation to an individual, means -

(a) spouse of the individual;

(b) brother or sister of the individual;

(c) brother or sister of the spouse of the individual;

(d) any lineal ascendant or descendant of the individual;

(e) any lineal ascendant or descendant of the spouse of the individual;

(f) spouse of a person referred to in (b), (c), (d) or (e) above;

(g) any lineal descendant of a brother or sister of either the individual or the spouse of the individual;

Substantial interest in a concern - Section 13(2)(h), section 13(3) and section 13(4) refers to cases where a person has a substantial interest in a concern. These references occur where the "Prohibited use or application" and "Prohibited category of persons" have been described. The circumstances in which a person shall be deemed to have a substantial interest in a concern, have been laid down in Explanation 3 to section 13. Accordingly, a person shall be deemed to have a substantial interest in a concern -

(i) Where the concern is a company, if its shares, other than preference shares,

carrying not less than 20 per cent of the voting power are, at any time during the previous year, owned beneficially by him alone or partly by him and partly by one or more of the other persons referred to in section 13(3).

(ii) When the concern is not a company, if he is entitled or he and one or more of the other persons referred to in section 13(3) are entitled in the aggregate, at any time during the previous year, to not less than 20 per cent of the profits of such concern.

(5) ANONYMOUS DONATIONS RECEIVED BY CHARITABLE TRUSTS/INSTITUTIONS TO BE SUBJECT TO TAX [SECTION 115BBC]

(i) As per the provisions of the Income-tax Act, 1961, tax exemption under section 10(23C) and section 11 are available to certain entities, as briefed in the table below, on fulfillment of the conditions prescribed under the relevant sections –

Entity	Applicable section
Charitable or religious trusts/institutions	11
Universities and other educational institutions	10(23C)(iiiad) and (vi)
Hospitals and other medical institutions	10(23C) (iiiae) and (via)
Notified funds or institutions established for charitable purposes	10(23C)(iv)
Notified trusts or institutions established wholly for public religious purposes or wholly for public religious and charitable purposes	10(23C)(v)

(ii) Section 115BBC has been inserted to tax anonymous donations received by the above entities at 30%.

(iii) In order to provide relief to these trusts and institutions and to reduce their compliance burden, an exemption limit has been introduced, and only the anonymous donations in excess of this limit would be subject to tax@30% under section 115BBC.

(iv) The exemption limit is the higher of the following –

(1) 5% of the total donations received by the assessee; or

(2) Rs.1 lakh.

(v) The total tax payable by such institutions would be –

(1) tax@30% on anonymous donations exceeding the exemption limit as calculated above; and

(2) tax on the balance income i.e. total income as reduced by the aggregate of anonymous donations received.

(v) The following table illustrates the calculation of anonymous donations liable to tax @30% under section 115BBC –

Situation	*Total donations during the year (Rs.)*	*Anonymous donations received during the year (Rs.)*	*Exemption (Rs.)*	*Anonymous donations taxable@30% (Rs.)*
1	*15,00,000*	*4,00,000*	*1,00,000*	*3,00,000*
2	*30,00,000*	*7,00,000*	*1,50,000*	*5,50,000*
3	*40,00,000*	*10,00,000*	*2,00,000*	*8,00,000*

(vi) For this purpose, "anonymous donation" means any voluntary contribution referred to in section 2(24)(iia), where the person receiving such contribution does not maintain a record of the identity indicating the name and address of the person making such contribution and such other particulars as may be prescribed.

(vii) However, the above provision does not apply to a trust or institution created or established wholly for religious purposes.

(viii) Further, anonymous donations to trusts/institutions created or established wholly for religious and charitable purposes (i.e. partly charitable and partly religious institutions/trusts) would be taxed only if such anonymous donation is made with a specific direction that such donation is for any university or other educational institution or any hospital or other medical institution run by such trust or institution. Other anonymous donations received by such trusts/institutions are not taxable.

(ix) Section 13(7) provides that the exemption provisions contained in section 11 or section 12 shall not be applicable in respect of any anonymous donation referred to in section 115BBC on which tax is payable in accordance with the provisions of that section.

(x) For example, section 11(1)(d) of the Act provides that any income in the form of voluntary contributions made with a specific direction that they shall form part of the corpus of the trust or institution shall not be included in the total income of such trust/institution for the relevant previous year. However, if a trust or institution established wholly for charitable purposes receives an anonymous donation with a specific direction that the donation shall form part of the corpus of the trust or institution, such anonymous donation would not be exempt by virtue of section 11(1)(d). It would be taxable at 30% as provided in section 115BBC.

(xi) Similarly, section 10(23C) provides that any anonymous donation referred to in section 115BBC on which tax is payable in accordance with the provisions of the said section shall be included in the total income. The amendments to section 10(23C) and 13 are consequential amendments to provide that any income by way of any anonymous donation which is taxable under the provisions of section 115BBC shall not be excluded from the total income of the trust or institution.

3.88 Income Tax

(6) TAX EXEMPTION TO POLITICAL PARTIES

Section 13A of the Income-tax Act grants exemption from tax to political parties in respect of their income specified below:

(i) Income from house property;

(ii) Income from other sources;

(iii) Capital gains; and

(iv) Income by way of voluntary contributions received by the political parties from any person.

The aforesaid categories of income would qualify for exemption without any monetary or other limit and the income so exempted would not even be includible in the total income of the political party for the purpose of assessment. The tax exemption will be applicable only if the following conditions are fulfilled:

(i) The political party must keep and maintain such books and other documents as would enable the Assessing Officer to properly deduce the income of the political party from those accounts.

(ii) The political party must keep and maintain records in `respect of each such voluntary contribution which is in excess of Rs.20,000 giving details of the amount received, the name and address of the person who has made the contribution, the date of receipt and such other details as may be relevant or appropriate. However, this does not mean that the political party need not disclose smaller contributions in its accounts which are maintained by it. The obligation to maintain proper record of voluntary contribution in excess of Rs.20,000 is over and above the obligation to maintain proper records and books of accounts in respect of all the income and expenses of the party.

(iii) The accounts of the political party must be audited by a Chartered Accountant.

(iv) A report under section 29C(3) of the Representation of People Act, 1951 has to be submitted by the treasurer of such political party or any other person authorised by the political party in this behalf for every financial year. If there is a failure to submit the above report, no exemption under this section shall be available for the political party for that financial year.

For the purposes of this section, “political party” means a political party registered under section 29A of the Representation of the People Act, 1951.

(7) EXEMPTION FOR VOLUNTARY CONTRIBUTIONS RECEIVED BY ELECTORAL TRUSTS [SECTION 13B]

(i) Any voluntary contribution received by an electoral trust (as may be approved by the

CBDT in accordance with the scheme to be made by the Central Government) shall be treated as its income under section 2(24), but shall be exempt under new section 13B, if the trust distributes to a registered political party during the year, 95% of the aggregate donations received by it during the year along with the surplus if any, brought forward from any earlier previous year.

(ii) Another condition for availing the benefit under this section is that the electoral trust should function in accordance with the rules made by the Central Government.

Self-examination questions

1. The Income-tax Act grants exemption from tax to political parties in respect of their income. State the incomes so exempted as per the provisions of the Act.
2. Explain the meaning of the following terms in the context of section 10AA -
   (a) Export;
   (b) Export turnover;
   (c) Manufacture.
3. Is benefit of deduction under section 10B available to undertakings set up in domestic tariff area (DTA) subsequently approved as a 100% export oriented undertaking (100% EOU)? If yes, from which year and for what period is such deduction available?
4. (a) Discuss the exemption available under the Income-tax Act in respect of specified income arising from any international sporting event in India.
   (b) What are the exemptions available under section 10 in respect of companies engaged in the business of generation or transmission or distribution of power and subsidiaries of such companies? What are the conditions to be fulfilled to avail such exemptions?
5. Explain about aggregation of agricultural income for rate purposes. How will income-tax be computed where an individual derives agricultural as well as non-agricultural income?
6. Discuss the provisions of section 10AA in respect of tax holiday for newly established units in a special economic zone.
7. What is the exemption available under the clauses (39), (40) and (41) of section 10?
8. When can a charitable trust avail benefits under section 11 & 12 of the Income-tax Act, 1961?
9. Discuss the meaning and tax treatment of anonymous donations received by charitable/religious trusts/institutions.
10. Mr. Ganesh, an employee of a co-operative bank, received a certain sum by way of leave encashment while in service from his employer, in respect of which he claimed exemption under section 10(10AA), on the contention that the words 'or otherwise' in section 10(10AA) clearly indicated that the exemption was to be given as and when there

was a payment to the assessee in lieu of leave encashment and the words 'or otherwise' therein did not restrict the purview of the exemption to retiring employees only. Is Mr. Ganesh correct in claiming exemption under section 10(10AA) in respect of leave encashment received by him while in service? Discuss.

11. Heritage Public Charitable Trust runs a hospital, which derived income of Rs.325 lakh from its operational activities. Expenses incurred to earn such income are Rs.80 lakh. Depreciation on various assets used in the hospital is Rs.22 lakh. Out of the income of Rs.325 lakhs, the amount accrued but not received as on 31.3.2010 is Rs.45 lakh. The institution earmarked and set apart Rs.42 lakhs in March, 2009 to give as advance for a floor of a building intended to be taken on lease for transfer of the Neurology department of the hospital, but the amount was paid on 13th April, 2010, as the lease agreement could not be signed by 31st March, 2010. The trust has got a software package developed and installed by Infosys during the year. The total cost to the trust on account of the software package was Rs.72 lakh. The trust has also incurred Rs.23 lakh for purchase of computer systems for use in the hospital. Compute the total income of the trust for A.Y.2010-11.

12. A charitable trust registered under section 12AA of the Income-tax Act, 1961 has, out of its income of Rs.3,90,000 for the year ending 31.3.2010 and sale proceeds of a capital asset, held by it for less than 36 months, amounting of Rs.9,60,000, purchased a building during the year ending 31.3.2010 for Rs.13,50,000. The capital asset was sold during the year ending 31.3.2010. The building is held only for charitable purposes. The trust claims that the purchase of the building amounts to application of its income for charitable purposes and that the capital gain arising on the sale of the capital asset is deemed to have been applied to charitable purposes. Are the claims made by the charitable trust valid in law?

Answers

10. This issue came up before the *Allahabad High Court in CIT v. Vijai Pal Singh (2005) 144 Taxman 504*. The High Court observed that the words 'or otherwise' would draw the restricted meaning *qua* the immediately preceding word 'superannuation'. The superannuation is of an employee's severance of relationship of contract of employment with the employer. The phrase 'or otherwise' would cover only such an eventuality when there is severance of relationship of employer and employee and contract of employment. Therefore, the phrase 'or otherwise' will not cover such cases where there is no severance of relationship of employer and employee and the assessee continues to be under the employment of the same employer, and receives leave encashment. The Court held that this interpretation is in consonance with the legislative history of the section and it manifests the intention of the Legislature to give a limited benefit to an employee with respect to the income received by the employee at the time of his retirement or superannuation or severance of relationship.

Therefore, in view of the above case, exemption under section 10(10AA) cannot be claimed by Mr. Ganesh in respect of leave encashment received by him while in service from his employer.

11. The total income of Heritage Charitable Trust for the A.Y. 2010-11 is computed hereunder:

Particulars			Rs. in lakhs
Income derived from property held under trust			325.00
Less:	Expenses incurred thereto	80	
	Depreciation on assets	22	102.00
			223.00
Less:	15% to be set apart (15% of Rs.223 lakhs)		33.45
			189.55
Less:	Income not received during the year, which can be spent in the year of receipt or in the immediately following year		45.00
			144.55
Less:	Non-application of income due to delay in signing lease agreement [The amount was applied on 13.4.2010 i.e. in the immediately following year – Option to be exercised in writing before the expiry of the time allowed under section 139(1) for furnishing the return of income]		42.00
Amount to be applied for the objects of the trust by 31.3.2010			**102.55**
Less:	Amount applied for the objects of the trust		
	(i) For development and installation of a software package for the purpose of the trust	72	
	(ii) For purchase of computer systems for the purpose of the trust	23	95.00
Taxable Income			**7.55**

Note – (i) If the income applied to charitable purposes in India falls short of 85% of the income derived during the year from property held under trust for the reason that the whole or any part of its income has not been received during that year, then such income, at the option of the person in receipt of income, can be applied during the previous year in which the income is received or in the immediately following previous year. The option is to be exercised in writing before expiry of the time allowed u/s 139(1) for filing return of income.

(ii) The cost of developing a software package and installing the same is a capital

expenditure. A charitable trust can apply its income either for revenue purposes or for capital purposes, provided the expenditure is incurred for promoting the objects of the trust. Purchase of a fixed asset to be utilised for the purpose of the trust amounts to application of income for charitable purposes as held by the Supreme Court in *S.RM.M.CT.M.Tiruppani Trust vs. CIT(1998) 230 ITR 636.*

12. Section 11(1)(a) stipulates that in order to avail exemption of income derived from property held under trust wholly for charitable or religious purposes, the trust is required to apply for charitable or religious purposes, 85% of its income from such property for the year. In this case, the trust has earned income of Rs.3,90,000 for the year ending 31.3.2010. It has also earned short term capital gain from sale of capital asset for Rs.9,60,000. The trust had utilized the entire amount of Rs.13,50,000 for the purchase of a building held for charitable purposes.

The Supreme Court in *S.RM. M. CT. M. Tiruppani Trust v. CIT (1998) 230 ITR 636* ruled that the assessee-trust, which applied its income for charitable purposes by purchasing a building for use as a hospital, was entitled to exemption under section 11(1) in respect of such income. The ratio of the decision squarely applies to the case of the charitable trust in question. Therefore, the charitable trust is justified in claiming that the purchase of the building amounted to application of its income for charitable purposes.

Under section 11(1A), where the whole of the sale proceeds of a capital asset held by a charitable trust is utilised by it for acquiring another capital asset, the capital gain arising therefrom is deemed to have been applied to charitable purposes and would be exempt. Section 11(1A) does not make any distinction between a long-term capital asset and a short-term capital asset. The claim of the charitable trust to the effect that the capital gain is deemed to have been applied to charitable purposes is, therefore, in accordance with law.

4

INCOME FROM SALARIES

4.1 SALARY

The meaning of the term 'salary' for purposes of income tax is much wider than what is normally understood. Every payment made by an employer to his employee for service rendered would be chargeable to tax as income from salaries. The term 'salary' for the purposes of Income-tax Act will include both monetary payments (e.g. basic salary, bonus, commission, allowances etc.) as well as non-monetary facilities (e.g. housing accommodation, medical facility, interest free loans etc).

(1) Employer-employee relationship : Before an income can become chargeable under the head 'salaries', it is vital that there should exist between the payer and the payee, the relationship of an employer and an employee. Consider the following examples:

(a) Sujatha, an actress, is employed in Chopra Films, where she is paid a monthly remuneration of Rs.2 lakh. She acts in various films produced by various producers. The remuneration for acting in such films is directly paid to Chopra Films by the different producers. In this case, Rs.2 lakh will constitute salary in the hands of Sujatha, since the relationship of employer and employee exists between Chopra Films and Sujatha.

(b) In the above example, if Sujatha acts in various films and gets fees from different producers, the same income will be chargeable as income from profession since the relationship of employer and employee does not exist between Sujatha and the film producers.

(c) Commission received by a Director from a company is salary if the Director is an employee of the company. If, however, the Director is not an employee of the company, the said commission cannot be charged as salary but has to be charged either as income from business or as income from other sources depending upon the facts.

(d) Salary paid to a partner by a firm is nothing but an appropriation of profits. Any salary, bonus, commission or remuneration by whatever name called due to or received by partner of a firm shall not be regarded as salary. The same is to be charged as income from profits and gains of business or profession. This is primarily because the relationship between the firm and its partners is not that of an employer and employee.

(2) Full-time or part-time employment: It does not matter whether the employee is a full-time employee or a part-time one. Once the relationship of employer and employee exists, the income is to be charged under the head "salaries". If, for example, an employee works with more than one employer, salaries received from all the employers should be clubbed and brought to charge for the relevant previous years.

(3) Foregoing of salary: Once salary accrues, the subsequent waiver by the employee does not absolve him from liability to income-tax. Such waiver is only an application and hence, chargeable to tax.

Example: Mr. A, an employee instructs his employer that he is not interested in receiving the salary for April 2009 and the same might be donated to a charitable institution. In this case, Mr. A cannot claim that he cannot be charged in respect of the salary for April 2009. It is only due to his instruction that the donation was made to a charitable institution by his employer. It is only an application of income. Hence, the salary for the month of April 2009 will be taxable in the hands of Mr. A. He is however, entitled to claim a deduction under section 80G for the amount donated to the institution. [The concept of deductions is explained in detail in Chapter 7].

(4) Surrender of salary: However, if an employee surrenders his salary to the Central Government under section 2 of the Voluntary Surrender of Salaries (Exemption from Taxation) Act, 1961, the salary so surrendered would be exempt while computing his taxable income.

(5) Salary paid tax-free: This, in other words, means that the employer bears the burden of the tax on the salary of the employee. In such a case, the income from salaries in the hands of the employee will consist of his salary income and also the tax on this salary paid by the employer.

4.2 DEFINITION OF SALARY

The term 'salary' has been defined differently for different purposes in the Act. The definition as to what constitutes salary is very wide. As already discussed earlier, it is an inclusive definition and includes monetary as well as non-monetary items. There are different definitions of 'salary' say for calculating exemption in respect of gratuity, house rent allowance etc.

'Salary' under section 17(1), includes the following:

(i) wages,

(ii) any annuity or pension,

(iii) any gratuity,

(iv) any fees, commission, perquisite or profits in lieu of or in addition to any salary or wages,

(v) any advance of salary,

(vi) any payment received in respect of any period of leave not availed by him i.e. leave salary or leave encashment,

(vii) the portion of the annual accretion in any previous year to the balance at the credit of an

employee participating in a recognised provident fund to the extent it is taxable and

(viii) transferred balance in recognized provident fund to the extent it is taxable,

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

4.3 BASIS OF CHARGE

1. Section 15 deals with the basis of charge. Salary is chargeable to tax either on 'due' basis or on 'receipt' basis whichever is earlier.

2. However, where any salary, paid in advance, is assessed in the year of payment, it cannot be subsequently brought to tax in the year in which it becomes due.

3. If the salary paid in arrears has already been assessed on due basis, the same cannot be taxed again when it is paid.

Examples:

i. If A draws his salary in advance for the month of April 2010 in the month of March 2010 itself, the same becomes chargeable on **receipt basis** and is to be assessed as income of the P.Y.2009-10 i.e., A.Y.2010-11. However, the salary for the A.Y.2011-12 will not include that of April 2010.

ii. If the salary due for March 2010 is received by A later in the month of April 2010 only, it is still chargeable as income of the P.Y.2009-10 i.e. A.Y.2010-11 on **due basis.** Obviously, salary for the A.Y.2011-12 will not include that of March 2010.

4.4 PLACE OF ACCRUAL OF SALARY

Under section 9(1)(ii), salary earned in India is deemed to accrue or arise in India even if it is paid outside India or it is paid or payable after the contract of employment in India comes to an end.

Example: If an employee gets pension paid abroad in respect of services rendered in India, the same will be deemed to accrue in India. Similarly, leave salary paid abroad in respect of leave earned in India is deemed to accrue or arise in India.

Suppose, for example, A, a citizen of India is posted in the United States as our Ambassador. Obviously, he renders his services outside India. He also receives his salary outside India. He is also a non-resident. The question, therefore, arises whether he can claim exemption in respect of his salary paid by the Government of India to him outside India. Under general principles of income tax such salary cannot be charged in his hands. For this purpose, section 9(1)(iii) provides that salaries payable by the Government to a citizen of India for services outside India shall be deemed to accrue or arise in India. However, by virtue of section 10(7), any allowance or perquisites paid or allowed outside India by the Government to a citizen of India for rendering services outside India will be fully exempt.

4.4 Income Tax

4.5 PROFITS IN LIEU OF SALARY

It includes the following:

(i) 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.

(ii) The amount of any compensation due to or received by an assessee from his employer or former employer at or in connection with the modification of the terms and conditions of employment. Usually, such compensation is treated as a capital receipt. However, by virtue of this provision, the same is treated as a revenue receipt and is chargeable as salary.

Note: It is to be noted that merely because a payment is made by an employer to a person who is his employee does not automatically fall within the scope of the above provisions. The payment must be arising due to master-servant relationship between the payer and the payee. If it is not on that account, but due to considerations totally unconnected with employment, such payment is not profit in lieu of salary.

Example: A was an employee in a company in Pakistan. At the time of partition, he migrated to India. He suffered loss of personal movable property in Pakistan due to partition. He applied to his employer for compensating him for such loss. Certain payments were given to him as compensation. It was held that such payments should not be taxed as 'profit in lieu of salary' - *Lachman Dass Vs. CIT [1980] 124 ITR 706 (Delhi).*

(iii) Any payment due to or received by an assessee from his employer or former employer from an unrecognised provident fund or from an unrecognized superannuation fund to the extent to which it does not consist of employee's contributions or interest on such contributions.

Example: If any sum is paid to an employee from an unrecognised provident fund it is to be dealt with as follows :

(a) that part of the sum which represents the employer's contribution to the fund and interest thereon is taxable under salaries.

(b) that part of the sum which represents employee's contribution and interest thereon is not chargeable to tax since the same have already been taxed under the head 'salaries' and 'other sources' respectively on an yearly basis.

Note: It does not include exempt payments from superannuation fund, gratuity, commuted pension, retrenchment compensation, HRA.

(iv) Any payment due to or received by an assessee under a Keyman Insurance policy including the sum allocated by way of bonus on such policy.

(v) Any amount, whether in lumpsum or otherwise, due to the assessee or received by him, from any person -

(a) before joining employment with that person, or

(b) after cessation of his employment with that person.

(vi) Any other sum received by the employee from the employer.

For a better and simpler understanding, this chapter has been discussed under three broad categories: Payments, Allowances and Perquisites.

4.6 ADVANCE SALARY

Advance salary is taxable when it is received by the employee irrespective of the fact whether it is due or not. It may so happen that when advance salary is included and charged in a particular previous year, the rate of tax at which the employee is assessed may be higher than the normal rate of tax to which he would have been assessed. Section 89(1) provides for relief in these types of cases. [The concept of relief under section 89(1) is explained in para 4.23 of this Chapter].

4.7 LOAN OR ADVANCE AGAINST SALARY

Loan is different from salary. When an employee takes a loan from his employer, which is repayable in certain specified installments, the loan amount cannot be brought to tax as salary of the employee.

Similarly, advance against salary is different from advance salary. It is an advance taken by the employee from his employer. This advance is generally adjusted with his salary over a specified time period. It cannot be taxed as salary.

4.8 SALARY ARREARS

Normally speaking, salary arrears must be charged on due basis. However, there are circumstances when it may not be possible to bring the same to charge on due basis. For example if the Pay Commission is appointed by the Central Government and it recommends revision of salaries of employees, the arrears received in that connection will be charged on receipt basis. Here, also relief under section 89(1) is available.

4.9 ANNUITY

1. As per the definition, 'annuity' is treated as salary. Annuity is a sum payable in respect of a particular year. It is a yearly grant. If a person invests some money entitling him to series of equal annual sums, such annual sums are annuities in the hands of the investor.
2. Annuity received by a present employer is to be taxed as salary. It does not matter whether it is paid in pursuance of a contractual obligation or voluntarily.
3. Annuity received from a past employer is taxable as profit in lieu of salary.
4. Annuity received from person other than an employer is taxable as "income from other sources".

4.6 Income Tax

4.10 GRATUITY [SECTION 10(10)]

Gratuity is a voluntary payment made by an employer in appreciation of services rendered by the employee. Now-a-days gratuity has become a normal payment applicable to all employees. In fact, Payment of Gratuity Act, 1972 is a statutory recognition of the concept of gratuity. Almost all employers enter into an agreement with employees to pay gratuity. For details refer to Chapter 3.

4.11 PENSION

Concise Oxford Dictionary defines 'pension' as a periodic payment made especially by Government or a company or other employers to the employee in consideration of past service payable after his retirement.

Commuted pension: Commutation means inter-change. Many persons convert their future right to receive pension into a lumpsum amount receivable immediately. For example, suppose a person is entitled to receive a pension of say Rs.2000 p.m. for the rest of his life. He may commute ¼th i.e. 25% of this amount and get a lumpsum of say Rs.30,000. After commutation, his pension will now be the balance 75% of Rs.2,000 p.m. = Rs.1,500 p.m.

For details refer to Chapter 3.

4.12 LEAVE SALARY [SECTION 10(10AA)]

For details refer to Chapter 3.

4.13 RETRENCHMENT COMPENSATION [SECTION 10(10B)]

For details refer to Chapter 3.

4.14 COMPENSATION RECEIVED ON VOLUNTARY RETIREMENT [SECTION 10(10C)]

Any compensation received by an employee of a public sector company or of any other company or other specified bodies at the time of his voluntary retirement or termination of his service is exempt upto a maximum limit of Rs.5,00,000. However, such payment should be in accordance with a scheme of voluntary retirement or in the case of a public sector company, a scheme of voluntary separation. Such schemes should be in accordance with prescribed guidelines. These guidelines may include economic viability as one of the criteria.

For details refer to Chapter 3.

4.15 PROVIDENT FUND

Provident fund scheme is a scheme intended to give substantial benefits to an employee at the time of his retirement. Under this scheme, a specified sum is deducted from the salary of the employee as his contribution towards the fund. The employer also generally contributes the same amount out of his pocket, to the fund. The contribution of the employer and the employee are invested in approved securities. Interest earned thereon is also credited to the account of the employee. Thus, the credit balance in a provident fund account of an employee

consists of the following:

(i) employee's contribution

(ii) interest on employee's contribution

(iii) employer's contribution

(iv) interest on employer's contribution.

The accumulated balance is paid to the employee at the time of his retirement or resignation. In the case of death of the employee, the same is paid to his legal heirs.

The provident fund represents an important source of small savings available to the Government. Hence, the Income-tax Act gives certain *deductions* on savings in a provident fund account.

There are four types of provident funds :

(i) Statutory Provident Fund (SPF)

(ii) Recognised Provident Fund (RPF)

(iii) Unrecognised Provident Fund (UPF)

(iv) Public Provident Fund (PPF)

The tax treatment is given below:

Particulars	Recognized PF	Unrecognized PF	Statutory PF	Public PF
Employer's Contribution	Amount in excess of 12% of salary is taxable	Not taxable yearly	Fully exempt	Not applicable as there is only assessee's own contribution
Employee's Contribution	Eligible for deduction u/s 80C	Not eligible for deduction	Eligible for deduction u/s 80C	Eligible for deduction u/s 80C
Interest Credited	Amount in excess of 9.5% p.a. is taxable	Not taxable yearly	Fully exempt	Fully exempt
Amount received on retirement, etc.	See Note (1)	See Note (3)	Fully exempt u/s 10(11).	Fully exempt u/s 10(11)

Notes:

(1) Amount received on the maturity of RPF is fully exempt in case of an employee who has rendered continuous service for a period of 5 years or more. In case the maturity of RPF takes place within 5 years then the amount received would be fully exempt only if the

service had been terminated due to employee's ill-health or discontinuance or contraction of employer's business or other reason beyond control of the employee. In any other case, the amount received will be taxable in the same manner as that of an URPF.

(2) If, after termination of his employment with one employer, the employee obtains employment under another employer, then, only so much of the accumulated balance in his provident fund account will be exempt which is transferred to his individual account in a recognised provident fund maintained by the new employer. In such a case, for exemption of payment of accumulated balance by the new employer, the period of service with the former employer shall also be taken into account for computing the period of five years' continuous service.

(3) Employee's contribution is not taxable but interest thereon is taxable under 'Income from Other Sources'. Employer's contribution and interest thereon is taxed as Salary.

(4) Salary for this purpose means basic salary and dearness allowance - if provided in the terms of employment for retirement benefits and commission as a percentage of turnover.

(1) Statutory Provident Fund (SPF): The SPF is governed by Provident Funds Act, 1925. It applies to employees of government, railways, semi-government institutions, local bodies, universities and all recognised educational institutions. Under the Income-tax Act, the rules governing the SPF are as follows:

(2) Recognised Provident Fund (RPF): Recognised provident fund means a provident fund recognised by the Commissioner of Income-tax for the purposes of income-tax. It is governed by Part A of Schedule IV to the Income-tax Act. This schedule contains various rules regarding the following:

(a) Recognition of the fund

(b) Employee's and employer's contribution to the fund

(c) Treatment of accumulated balance etc.

A fund constituted under the Employees's Provident Fund and Miscellaneous Provisions Act, 1952 will also be a Recognised Provident Fund.

(3) Unrecognised Provident Fund (URPF): A fund not recognised by the Commissioner of Income-tax is Unrecognised Provident Fund.

(4) Public Provident Fund (PPF): Public provident fund is operated under the Public Provident Fund Act, 1968. A membership of the fund is open to every individual though it is ideally suited to self-employed people. A salaried employee may also contribute to PPF in addition to the fund operated by his employer. An individual may contribute to the fund on his own behalf as also on behalf of a minor of whom he is the guardian.

For getting a deduction under section 80C, a member is required to contribute to the PPF a minimum of Rs.500 in a year. A maximum amount that may qualify for deduction on this

account is Rs.70,000 as per PPF rules.

A member of PPF may deposit his contribution in as many installments in multiples of Rs.500 as is convenient to him. The sums contributed to PPF earn interest at 8%. The amount of contribution may be paid at any of the offices or branch offices of the State Bank of India or its subsidiaries and specified branches of Nationalised Banks or any Head Post Office.

Illustration 1

Mr. A retires from service on December 31, 2009, after 25 years of service. Following are the particulars of his income/investments for the previous year 2009-10:

Particulars	**Rs.**
Basic pay @ Rs.16,000 per month for 9 months	1,44,000
Dearness pay (50% forms part of the retirement benefits) Rs.8,000 per month for 9 months	72,000
Lumpsum payment received from the Unrecognised Provident Fund	6,00,000
Deposits in the PPF account	40,000

Out of the amount received from the provident fund, the employer's share was Rs.2,20,000 and the interest thereon Rs.50,000. The employee's share was Rs.2,70,000 and the interest thereon Rs.60,000.

What is the taxable portion of the amount received from the unrecognized provident fund in the hands of Mr. A for the assessment year 2010-11?

Solution

Taxable portion of the amount received from the URPF in the hands of Mr. A for the A.Y. 2010-11 is computed hereunder:

Amount taxable under the head "Salaries":

Employer's share in the payment received from the Unrecognized Provident Fund	Rs.2,20,000
Interest on the employer's share	Rs. 50,000
Total	Rs.2,70,000

Amount taxable under the head "Income from Other Sources" :

Interest on the employee's share	Rs. 60,000
Total amount taxable from the amount received from the fund	Rs.3,30,000

Note: Since the employee is not eligible for deduction under section 80C for contribution to URPF at the time of such contribution, the employee's share received from the URPF is not taxable at the time of withdrawal as this amount has already been taxed as his salary income.

Illustration 2

Will your answer be any different if the fund mentioned above was a recognised provident fund?

Solution

Since the fund is a recognised one, and the maturity is taking place after a service of 25 years, the entire amount received on the maturity of the RPF will be fully exempt from tax.

Illustration 3

Mr. B is working in XYZ Ltd. and has given the details of his income for the P.Y. 2009-10. You are required to compute his gross salary from the details given below:

Basic Salary	Rs.10,000 p.m.
D.A. (50% is for retirement benefits)	Rs.8,000 p.m.
Commission as a percentage of turnover	1%
Turnover during the year	Rs.5,00,000
Bonus	Rs.40,000
Gratuity	Rs.25,000
His own contribution in the RPF	Rs.20,000
Employer's contribution to RPF	20% of his basic salary
Interest accrued in the RPF @ 13% p.a.	Rs.13,000

Solution

Computation of Gross Salary of Mr. B for the A.Y.2010-11

Particulars	Rs.	Rs.
Basic Salary [Rs.10,000 × 12]		1,20,000
Dearness Allowance [Rs.8,000 × 12]		96,000
Commission on turnover [1% × Rs.5,00,000]		5,000
Bonus		40,000
Gratuity [Note 1]		25,000
Employee's contribution to RPF [Note 2]		-
Employers contribution to RPF [20% of Rs.1,20,000]	24,000	
Less : Exempt [Note 3]	20,760	3,240
Interest accrued in the RPF @ 13% p.a.	13,000	
Less : Exempt @ 9.5% p.a.	9,500	3,500
Gross Salary		**2,92,740**

Note 1 : Gratuity received during service is fully taxable.

Note 2 : Employee's contribution to RPF is not taxable. It is eligible for deduction under section 80C.

Note 3 : Employers contribution in the RPF is exempt up to 12% of the salary.

i.e. 12% of [B.S + D.A. for retirement benefits + Commission based on turnover]

= 12% of [Rs.1,20,000 + (50% × Rs.96,000) + Rs.5,000]

= 12% of Rs.1,73,000

= Rs.20,760

4.16 APPROVED SUPERANNUATION FUND

It means a superannuation fund which has been and continues to be approved by the Commissioner in accordance with the rules contained in Part B of the VIth Schedule to the Income-tax Act.

The tax treatment of contribution and exemption of payment from tax are as follows:

(i) Employer's contribution is exempt from tax in the hands of employee but taxable in the hands of the employer (only in respect of such contribution exceeding Rs.1,00,000 per employee per annum) under the provisions of fringe benefit tax;

(ii) Employee's contribution qualifies for deduction under section 80C;

(iii) Interest on accumulated balance is exempt from tax.

Section 10(13) grants exemption in respect of payment from the fund—

(a) to the legal heirs on the death of beneficiary (e.g. payment to widow of the beneficiary) or

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

(c) by way of refund of contribution on the death of the beneficiary or,

(d) by way of refund of contribution to an employee on his leaving the service in connection with which the fund is established otherwise than in the circumstances mentioned in (b), to the extent to which such payment does not exceed the contribution made prior to April 1, 1962. For example, where the amount received by an employee does not include any contribution made prior to 1-4-62, the whole amount is taxable.

4.17 SALARY FROM UNITED NATIONS ORGANISATION

Section 2 of the United Nations (Privileges and Immunities) Act, 1947 grants exemption from income-tax to salaries and emoluments paid by the United Nations to its officials. Besides salary, any pension covered under the United Nations (Privileges and Immunities) Act and received from UNO is also exempt from tax.

4.12 Income Tax

4.18 ALLOWANCES

Different types of allowances are given to employees by their employers. Generally allowances are given to employees to meet some particular requirements like house rent, expenses on uniform, conveyance etc. Under the Income-tax Act, allowance is taxable on due or receipt basis, whichever is earlier. Various types of allowances normally in vogue are discussed below:

Allowances		
Fully Taxable	**Partly Taxable**	**Fully Exempt**
(i) Entertainment Allowance	(i) House Rent Allowance [u/s 10(13A)]	(i) Allowance granted to Government employees outside India.
(ii) Dearness Allowance	(ii) Special Allowances [u/s 10(14)]	(ii) Sumptuary allowance granted to High Court or Supreme Court Judges
(iii) Overtime Allowance		(iii) Allowance paid by the United Nations Organization.
(iv) Fixed Medical Allowance		(iv) Compensatory Allowance received by a judge
(v) City Compensatory Allowance		
(vi) Interim Allowance (to meet increased cost of living in cities)		
(vii) Servant Allowance		
(viii) Project Allowance		
(ix) Tiffin/Lunch/Dinner Allowance		
(x) Any other cash allowance		
(xi) Warden Allowance		
(xii) Non-practicing Allowance		

Allowances which are fully taxable

(1) City compensatory allowance: City Compensatory Allowance is normally intended to compensate the employees for the higher cost of living in cities. It is taxable irrespective of the fact whether it is given as compensation for performing his duties in a particular place or under special circumstances.

(2) Entertainment allowance: This allowance is given to employees to meet the expenses towards hospitality in receiving customers etc. The Act gives a deduction towards entertainment allowance only to a Government employee. The details of deduction permissible are discussed later on in this Unit.

Allowances which are partially taxable

(1) House rent allowance [Section 10(13A)] – Refer to Chapter 3 for detailed discussion.

(2) Special allowances [Section 10(14)] : Refer to Chapter 3 for details.

Allowances which are fully exempt:

(1) Allowance to High Court Judges: Any allowance paid to a Judge of a High Court under section 22A(2) of the High Court Judges (Conditions of Service) Act, 1954 is not taxable.

(2) Allowance received from United Nations Organisation (UNO): Allowance paid by the UNO to its employees is not taxable by virtue of section 2 of the United Nations (Privileges and Immunities) Act, 1974.

(3) Compensatory allowance under Article 222(2) of the Constitution: Compensatory allowance received by judge under Article 222(2) of the Constitution is not taxable since it is neither salary not perquisite—*Bishamber Dayal Vs. CIT* [1976] 103 ITR 813 (MP).

(4) Sumptuary allowance : Sumptuary allowance given to High Court Judges under section 22C of the High Court Judges (Conditions of Service) Act, 1954 and Supreme Court Judges under section 23B of the Supreme Court Judges (Conditions of Service) Act, 1958 is not chargeable to tax.

4.19 PERQUISITES

(1) The term 'perquisite' indicates some extra benefit in addition to the amount that may be legally due by way of contract for services rendered. In modern times, the salary package of an employee normally includes monetary salary and perquisite like housing, car etc.

(2) Perquisite may be provided in cash or in kind.

(3) Reimbursement of expenses incurred in the official discharge of duties is not a perquisite.

(4) Perquisite may arise in the course of employment or in the course of profession. If it arises from a relationship of employer-employee, then the value of the perquisite is taxable as salary. However, if it arises during the course of profession, the value of such perquisite is chargeable as profits and gains of business or profession.

(5) Perquisite will become taxable only if it has a legal origin. An unauthorised advantage taken by an employee without his employer's sanction cannot be considered as a perquisite under the Act. For example, suppose A, an employee, is given a house by his employer. On 31.3.2010, he is terminated from service. But he continues to occupy the house without the permission of the employer for six more months after which he is evicted by the employer. The question arises whether the value of the benefit enjoyed by him during the six months period can be considered as a perquisite and be charged to salary. It cannot be done since the relationship of employer-employee ceased to exist after 31-3-2010. However, the definition of income is wide enough to bring the value of the benefit enjoyed by employee to tax as "income

from other sources".

(6) Income-tax paid by the employer out of his pocket on the salary of the employee is a perquisite in the hands of the employee whether the payment is contractual or voluntary.

Definition: Under the Act, the term 'perquisite' is defined by section 17(2) to include the following:

(a) the value of rent free accommodation provided to the assessee by his employer-section 17(2)(i);

(b) The value of any concession in the matter of rent respecting any accommodation provided to the assessee by his employer—section 17(2)(ii);

(i) Under section 17(2)(ii), the value of any concession in the matter of rent arising to an employee in respect of any accommodation provided by his employer is considered as "perquisite" chargeable to tax in the hands of the employee.

(ii) Rule 3(1) of the Income-tax Rules provides the basis of valuation of perquisites in respect of accommodation provided to an employee, as under:

(a) 15% of salary in cities having population exceeding 25 lakh

(b) 10% of salary in cities having population above 10 lakh up to 25 lakh

(b) 7.5% of salary in cities having population up to 10 lakh.

(iii) In case of furnished accommodation provided by an employer, the value arrived as above was to be further increased by 10 percent of the cost of furniture, where the same is owned by the employer, or the actual hire charges paid by the employer in case the furniture is hired.

(iv) This method of perquisite valuation resulted in genuine hardship to employees availing facility of residential accommodation in remote areas, as the value of perquisite was determined as a percentage of salary of the employee, irrespective of the fair rental value of the property (which may be much lower than 15%/10%/7.5% of salary in such cases).

(v) Rule 3(1) was challenged as *ultra vires* before the Supreme Court in the case of *Arun Kumar v. UOI (2006) 286 ITR 89*. The Apex court, while holding that the provisions of Rule 3(1) were constitutionally valid, observed that the same would be applicable only if 'concession in the matter of rent' with respect to the accommodation provided by an employer accrues to the employee under the substantive provisions of section 17(2)(ii). The Assessing Officer, before applying Rule 3(1), was required to establish that there was 'concession in the matter of rent' provided to the employee.

(vi) Further, as per the Apex court, the difference between the value as per Rule 3(1)

and the rent recovered from the employee, could not per se be considered as 'concession in the matter of rent' provided to the employee.

(vii) In order to clarify the correct intent of law, Explanations have been inserted in section 17(2)(ii) to provide that the difference between the specified rate (as shown in column 2 of the table below) and the amount of rent recoverable/recovered from the employee would be deemed to be the concession in the matter of rent in case of accommodation owned by the employer. In case of accommodation taken on lease or rent by the employer, the difference between the actual lease rent or 15% of salary, whichever is lower, and rent recovered/recoverable from the employee would be deemed to be the concession in the matter of rent.

(1)	(2)
Type of accomodation	**Deemed concession in the matter of rent**
Accommodation owned by the employer	
In cities having a population exceeding 25 lakh	15% of salary minus rent recoverable from the employee.
In cities having a population exceeding 10 lakh but not exceeding 25 lakh	10% of salary minus rent recoverable from the employee.
In other cities	7½% of salary minus rent recoverable from employee.
Accommodation taken on lease by the employer	Rent paid by the employer or 15% of salary, whichever is lower, minus rent recoverable from the employee.

(viii) This deeming provision is applicable to employees other than Government employees. In case of furnished accommodation provided to such employees, the excess of hire charges paid or 10% p.a. of cost of furniture, as the case may be, over and above the charges paid or payable by the employee would be added to the value determined in column (2) above for determining whether there is a concession in the matter of rent.

Note – Once there is a deemed concession, the provisions of Rule 3(1) would be applicable in computing the taxable perquisite.

(ix) "Salary" includes pay, allowances, bonus or commission payable monthly or otherwise or any monetary payment, by whatever name called, from one or more employers, as the case may be. However, it does not include the following, namely–

(1) dearness allowance or dearness pay unless it enters into the computation of superannuation or retirement benefits of the employee concerned;

(2) employer's contribution to the provident fund account of the employee;

(3) allowances which are exempted from the payment of tax;

(4) value of the perquisites specified in section 17(2);

(5) any payment or expenditure specifically excluded under the proviso to section 17(2) i.e., medical expenditure/payment of medical insurance premium specified therein.

(x) In case of Government employees, the excess of licence fees determined by the employer as increased by the value of furniture and fixture over and above the rent recovered/recoverable from the employee and the charges paid or payable for furniture by the employee would be deemed to be the concession in the matter of rent.

(c) The value of any benefit or amenity granted or provided free of cost or at concessional rate in any of the following cases (i.e. in case of specified employees):

(i) by a company to an employee in which he is a director;

(ii) by a company to an employee being a person who has substantial interest in the company (i.e. 20% or more of the voting rights of the company);

(iii) by any employer (including a company) to an employee to whom the provisions of (i) & (ii) do not apply and whose income under the head 'salaries' (whether due from, or paid or allowed by, one or more employers) exclusive of the value of all benefits or amenities not provided for by way of monetary benefits exceeds Rs.50,000 - section 17(2)(iii);

(d) Any sum paid by the employer in respect of any obligation which, but for such payment, would have been payable by the assessee - section 17(2)(iv);

(e) Any sum payable by the employer whether directly or through a fund, other than a recognised provident fund or approved superannuation fund or deposit- linked insurance fund to effect an assurance on the life of the assessee or to effect a contract for an annuity - section 17(2)(v).

(f) *the value of any specified security or sweat equity shares allotted or transferred, directly or indirectly, by the employer or former employer, free of cost or at concessional rate to the assessee – section 17(2)(vi).*

Specified security means "securities" as defined in section 2(h) of the Securities Contracts (Regulation) Act, 1956. It also includes the securities offered under employees stock option plan or scheme. Sweat equity shares means equity shares issued by a company to its employees or directors at a discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called.

The value of specified security or sweat equity shares shall be the fair market value of such security or shares on the date on which the option is exercised by the assessee, as reduced by any amount actually paid by, or recovered from, the assessee in respect of

such security or shares. The fair market value means the value determined in accordance with the method as may be prescribed by the CBDT. "Option" means a right but not an obligation granted to an employee to apply for the specified security or sweat equity shares at a pre-determined price.

(g) the amount of any contribution to an approved superannuation fund by the employer in respect of the assessee, to the extent it exceeds Rs.1 lakh – section 17(2)(vii).

(h) the value of any other fringe benefit or amenity as may be prescribed by the CBDT – section 17(2)(viii).

It can be noted that the aforesaid definition of perquisite is an inclusive one. More terms can be added in.

Types of perquisites: Perquisites may be divided into three broad categories:

(1) Perquisites taxable in the case of all employees

(2) Perquisites exempt from tax in the case of all employees

(3) Perquisites taxable only in the hands of specified employees.

(1) Perquisites taxable in the case of all employees: The following perquisites are chargeable to tax in all cases.

(i) Value of rent-free accommodation provided to the assessee by his employer [Section 17(2)(i)].

Exception: Rent-free official residence provided to a Judge of a High Court or to a Judge of the Supreme Court is not taxable. Similarly, rent-free furnished house provided to an Officer of Parliament, is not taxable. [For valuation, refer to para 4.20]

(ii) Value of concession in rent in respect of accommodation provided to the assessee by his employer [Section 17(2)(ii)].

(iii) Amount paid by an employer in respect of any obligation which otherwise would have been payable by the employee [Section 17(2)(iv)]. For example, if a domestic servant is engaged by an employee and the employer reimburses the salary paid to the servant, it becomes an obligation which the employee would have discharged even if the employer did not reimburse the same. This perquisite will be covered by section 17(2)(iv) and will be taxable in the hands of all employees.

(iv) Amount payable by an employer directly or indirectly to effect an assurance on the life of the assessee or to effect a contract for an annuity, other than payment made to RPF or approved superannuation fund or deposit-linked insurance fund established under the Coal Mines Provident Fund or Employees' Provident Fund Act. However, there are schemes like group annuity scheme, employees state insurance scheme and fidelity insurance scheme, under which insurance premium is paid by employer on behalf of the employees. Such payments are not regarded as perquisite in view of the fact that the employees have only an expectancy of the benefit in such schemes.

(v) the value of any specified security or sweat equity shares allotted or transferred, directly or indirectly, by the employer or former employer, free of cost or at concessional rate to

the assessee.

(vi) the amount of any contribution to an approved superannuation fund by the employer in respect of the assessee, to the extent it exceeds Rs.1 lakh.

(vii) The value of any other fringe benefit or amenity as may be prescribed by the CBDT.

(2) Perquisites exempt from tax in all cases: The following perquisites are exempt from tax in all cases -

(1) Telephone provided by an employer to an employee at his residence;

(2) Goods sold by an employer to his employees at concessional rates;

(3) Transport facility provided by an employer engaged in the business of carrying of passengers or goods to his employees either free of charge or at concessional rate;

(4) Privilege passes and privilege ticket orders granted by Indian Railways to its employees;

(5) Perquisites allowed outside India by the Government to a citizen of India for rendering services outside India;

(6) Sum payable by an employer to a RPF or an approved superannuation fund or deposit-linked insurance fund established under the Coal Mines Provident Fund or the Employees' Provident Fund Act;

(7) Employer's contribution to staff group insurance scheme;

(8) Leave travel concession;

(9) Payment of annual premium by employer on personal accident policy effected by him on the life of the employee;

(10) Refreshment provided to all employees during working hours in office premises;

(11) Subsidized lunch or dinner provided to an employee;

(12) Recreational facilities, including club facilities, extended to employees in general *i.e.,* not restricted to a few select employees;

(13) Amount spent by the employer on training of employees or amount paid for refresher management course including expenses on boarding and lodging;

(14) Medical facilities subject to certain prescribed limits; [Refer to point 11 of para 4.20]

(15) Rent-free official residence provided to a Judge of a High Court or the Supreme Court;

(16) Rent-free furnished residence including maintenance provided to an Officer of Parliament, Union Minister and a Leader of Opposition in Parliament;

(17) Conveyance facility provided to High Court Judges under section 22B of the High Court Judges (Conditions of Service) Act, 1954 and Supreme Court Judges under section 23A of the Supreme Court Judges (Conditions of Service) Act, 1958.

(3) Perquisites taxable only in the hands of specified employees [Section 17(2)(iii)]: The value of any benefit or amenity granted or provided free of cost or at concessional rate which have not been included in 1 & 2 above will be taxable in the hands of specified employees:

Specified employees are:

(i) Director employee: An employee of a company who is also a director is a specified employee. It is immaterial whether he is a full-time director or part-time director. It also does not matter whether he is a nominee of the management, workers, financial institutions or the Government. It is also not material whether or not he is a director throughout the previous year.

(ii) An employee who has substantial interest in the company: An employee of a company who has substantial interest in that company is a specified employee. A person has a substantial interest in a company if he is a beneficial owner of equity shares carrying 20% or more of the voting power in the company.

Beneficial and legal ownership: In order to determine whether a person has a substantial interest in a company, it is rather the beneficial ownership of equity shares carrying 20% or more of the voting power that is relevant rather than the legal ownership.

Example: A, Karta of a HUF, is a registered shareholder of Bright Ltd. The amount for purchasing the shares is financed by the HUF. The dividend is also received by the HUF. Supposing further that A is the director in Bright Ltd., the question arises whether he is a specified employee. In this case, he cannot be called, a specified person since he has no beneficial interest in the shares registered in his name. It is only for the purpose of satisfying the statutory requirements that the shares are registered in the name of A. All the benefits arising from the shareholding goes to the HUF. Conversely, it may be noted that an employee who is not a registered shareholder will be considered as a specified employee if he has beneficial interest in 20% or more of the equity shares in the company.

(iii) Employee drawing in excess of Rs.50,000: An employee other than an employee described in (i) & (ii) above, whose income chargeable under the head 'salaries' exceeds Rs.50,000 is a specified employee. The above salary is to be considered exclusive of the value of all benefits or amenities not provided by way of monetary payments.

In other words, for computing the limit of Rs.50,000, the following items have to be excluded or deducted:

(a) all non-monetary benefits;

(b) monetary benefits which are exempt under section 10. This is because the exemptions provided under section 10 are excluded completely from salaries. For example, HRA or education allowance or hostel allowance are not to be included in salary to the extent to which they are exempt under section 10.

(c) Deduction for entertainment allowance [under section 16(ii)] and deduction toward professional tax [under section 16(iii)] are also to be excluded.

If an employee is employed with more than one employer, the aggregate of the salary received from all employers is to be taken into account in determining the above ceiling limit of Rs.50,000, i.e. Salary for this purpose

= Basic Salary + D.A. + Commission, whether payable monthly or turnover based + Bonus + Fees + Any other taxable payment + Any taxable allowances + Any other monetary benefits – Deductions under section 16]

4.20 Income Tax

4.20 VALUATION OF PERQUISITES

The Income-tax Rules, 1962 contain the provisions for valuation of perquisites. It is important to note that only those perquisites which the employee actually enjoys have to be valued and taxed in his hand. For example, suppose a company offers a housing accommodation rent-free to an employee but the latter declines to accept it, then the value of such accommodation obviously cannot be evaluated and taxed in the hands of the employees. Rule 3 of the Income-tax Rules, 1962 contains the guidelines for the purpose of valuation of perquisites:

(1) Valuation of unfurnished accommodation: There are two ways in which a rent-free accommodation may be made available by an employer to his employee. He may own the housing accommodation and may give the same to the employee free of rent. He may also hire an accommodation on rent and give the same to the employee free of rent. In both the cases, the effect is that the employee gets rent-free accommodation. Provision of rent-free accommodation is a perquisite which **is taxable in the hands of all employees whether specified or non-specified.**

Note**:** "Accommodation" includes fixed structures like a house, flat, farm house or part thereof, or accommodation in a hotel, motel, service apartment, guest house, and floating structures like caravan, mobile home, ship or any other floating structure.

For the purpose of valuation of the perquisite in respect of unfurnished accommodation the employees are divided into two categories:

(A) Central and State Government employees (including military personnel):

The following employees come under this category:

(i) Central and State Government employees;

(ii) Government employees whose services have been lent to public sector undertaking or a Government body. In this case, the undertaking should have allotted the accommodation to employee.

Where accommodation is provided by Union or State Government to their employees either holding office or post in connection with the affairs of Union or State or serving with any body or undertaking under the control of such Government on deputation, the value of the perquisite will be equal to the licence fee determined by Union or State Government in respect of accommodation in accordance with the rules framed by that government as reduced by the rent actually paid by the employee.

∴ Value of perquisite = Licence Fees determined by Union / State Government – Rent actually paid by the employee.

Note: This provision does not include employees of a local authority (like port commission or Municipal Corporation) and foreign Government.

(B) Private sector employees - Those employees who are not covered under the earlier category mentioned above will be covered under this category for the purpose of determining the perquisite value of the accommodation.

Employee	Value of perquisite
Where the accommodation is owned by the employer.	Where accommodation is provided in a city where population as per 2001 census is: (a) 10 lakh or less – 7.5% of salary; (b) More than 10 lakh upto 25 lakh -10% of salary. (c) More than 25 lakh – 15% of salary in respect of the period during which the said accommodation was occupied by the employee during the previous year as reduced by the rent, if any, actually paid by the employee.
Where the accommodation is taken on lease or rent by the employer and provided to the employee	The value of perquisite would be the lower of the following: (a) Actual amount of lease rental paid or payable by the employer ; or (b) 15% of salary. This value would be reduced by the rent, if any, actually paid by the employee.

"Salary" for this purpose includes the basic pay, dearness allowance which forms part of salary for retirement benefits, taxable allowances, bonus or commission payable monthly or otherwise or any monetary payment, by whatever name called from one or more employers.

It does not include the following, namely:-

(a) dearness allowance, unless it enters into the computation of superannuation or retirement benefits of the employee concerned;

(b) Employer's contribution to the provident fund account of the employee;

(c) Allowances which are exempted from payment of tax;

(d) The value of perquisites specified under section 17(2) of the Income-tax Act;

(e) Any payment or expenditure in the nature of allotment of shares, debentures or warrants under ESOP or any other scheme;

(f) Any allowance in the nature of medical facility to the extent not taxable.

For computing salary, for the purpose of valuation of perquisite in respect of rent-free accommodation, basic salary, bonus etc. are to be considered on due basis.

Illustration 4

Mr. C is a Finance Manager in ABC Ltd. The company has provided him with rent-free unfurnished accommodation in Mumbai. He gives you the following particulars:

4.22 Income Tax

Basic salary	Rs.6,000 p.m.
Advance salary for April 2010	Rs.5,000
Dearness Allowance	Rs.2,000 p.m. (30% is for retirement benefits)
Bonus	Rs.1,500 p.m.

Even though the company allotted the house to him on 1.4.09, he occupied the same only from 1.11.09. Calculate the taxable value of the perquisite for A.Y. 2010-11.

Solution

Value of the rent free unfurnished accommodation

= 15% of salary for the relevant period

= 15% of [(Rs.6000 × 5) + (Rs.2,000 × 30% × 5) + (Rs.1,500 × 5)] [See Note below]

= 15% of Rs.40,500

= Rs.6,075.

Note: Since, Mr.C occupies the house only from 1.11.09, we have to include the salary due to him only in respect of months during which he has occupied the accommodation. Hence salary for 5 months (i.e. from 1.11.09 to 31.03.10) will be considered. Advance salary for April 2010 drawn during this year is not to be considered because it falls in respect of a period beyond the relevant previous year.

Illustration 5

Using the data given in the previous illustration 4, compute the value of the perquisite if Mr. C is required to pay a rent of Rs.1,000 p.m. to the company, for the use of this accommodation.

Solution

First of all, we have to see whether there is a concession in the matter of rent. In the case of accommodation owned by the employer in cities having a population exceeding Rs.25 lakh, there would be deemed to be a concession in the matter of rent if 15% of salary exceeds rent recoverable from the employee.

In this case, 15% of salary would be Rs.6,075 (i.e. 15% of Rs.40,500). The rent paid by the employee is Rs.5,000 (i.e. Rs.1,000 x 5). Since 15% of salary exceeds the rent recovered from the employee, there is a deemed concession in the matter of rent. Once there is a deemed concession, the provisions of Rule 3(1) would be applicable in computing the taxable perquisite.

Value of the rent free unfurnished accommodation	= Rs.6,075
Less : Rent paid by the employee (Rs.1,000 × 5)	= Rs.5,000
Perquisite value of unfurnished accommodation given at concessional rent	= Rs.1,075

Illustration 6

Using the data given in illustration 4, compute the value of the perquisite if ABC Ltd. has taken this accommodation on a lease rent of Rs.1,200 p.m. and Mr. C is required to pay a rent of Rs.1,000 p.m. to the company, for the use of this accommodation.

Solution

Here again, we have to see whether there is a concession in the matter of rent. In the case of accommodation taken on lease by the employer, there would be deemed to be a concession in the matter of rent if the rent paid by the employer or 15% of salary, whichever is lower, exceeds rent recoverable from the employee.

In this case, 15% of salary is Rs.6,075 (i.e. 15% of Rs.40,500). Rent paid by the employer is Rs.6,000 (i.e. Rs.1,200 x 5). The lower of the two is Rs.6,000, which exceeds the rent paid by the employee i.e. Rs.5,000 (Rs.1,000 x 5). Therefore, there is a deemed concession in the matter of rent. Once there is a deemed concession, the provisions of Rule 3(1) would be applicable in computing the taxable perquisite.

Value of the rent free unfurnished accommodation [Note1]	= Rs.6,000
Less: Rent paid by the employee (Rs.1,000 × 5)	= Rs.5,000
∴ Value of unfurnished accommodation given at concessional rent	= Rs.1,000

Note 1 : Value of the rent free unfurnished accommodation is lower of

(i) Lease rent paid by the company for relevant period = Rs.1,200 × 5 = Rs.6,000

(ii) 15% of salary for the relevant period (computed earlier) = Rs.6,075

(2) Valuation of furnished accommodation: When the accommodation provided to the employee is furnished by the employer, the computation of the value of the perquisite has to be done in the following manner:—

Step 1: Compute the value of the perquisite as if the accommodation is unfurnished.

Step 2: To the value arrived at in Step 1 above, add the value of furniture as follows:

(a) If the furniture is owned by the employer, then value of furniture is to be added on the basis of 10% p.a. of the original cost of the furniture, or

(b) If the employer has taken the furniture on hire, then value of furniture is the actual hire charges borne by the employer.

Note:

1. This addition in respect of furnished accommodation is applicable to all categories of employees.

2. In this context, the term 'furniture' will include TV sets, radio sets, refrigerators and other household appliances, air-conditioning plant or equipment or other similar appliances or gadgets.

4.24 Income Tax

Illustration 7

Using the data given in illustration 4, compute the value of the perquisite if ABC Ltd. has provided a television (WDV Rs.10,000; Cost Rs.25,000) and two air conditioners. The rent paid by the company for the air conditioners is Rs.400 p.m. each. The television was provided on 1.1.10. However, Mr. C is required to pay a rent of Rs.1,000 p.m. to the company, for the use of this furnished accommodation.

Solution

Here again, we have to see whether there is a concession in the matter of rent. In the case of accommodation owned by the employer in a city having a population exceeding Rs.25 lakh, there would be deemed to be a concession in the matter of rent if 15% of salary exceeds rent recoverable from the employee. In case of furnished accommodation, the excess of hire charges paid or 10% p.a. of the cost of furniture, as the case may be, over and above the charges paid or payable by the employee has to be added to the value arrived at above to determine whether there is a concession in the matter of rent.

In this case, 15% of salary is Rs.6,075 (i.e. 15% of Rs.40,500). The rent paid by the employee is Rs.5,000 (i.e. Rs.1,000 x 5). The value of furniture (see Note 1 below) to be added to 15% of salary is Rs.4,625. The deemed concession in the matter of rent is Rs.6,075+Rs.4,625-Rs.5,000 = Rs.5,700. Once there is a deemed concession, the provisions of Rule 3(1) would be applicable in computing the taxable perquisite.

Value of the rent free unfurnished accommodation (computed earlier)	= Rs.6,075
Add: Value of furniture provided by the employer [Note 1]	= Rs.4,625
Value of rent free furnished accommodation	= Rs.10,700
Less: Rent paid by the employee (Rs.1,000 × 5)	= Rs. 5,000
Value of furnished accommodation given at concessional rent	= Rs.5,700

Note 1: Value of the furniture provided

= (Rs.400 p.m. × 2 × 5 months) + (Rs.25,000 × 10% p.a. for 3 months)

= Rs.4,000 + Rs.625

= Rs.4,625

Illustration 8

Using the data given in illustration 7 above, compute the value of the perquisite if Mr. C is a government employee. The licence fees determined by the Government for this accommodation was Rs.700 p.m.

Solution

In the case of Government employees, the excess of licence fees determined by the employer as increased by the value of furniture and fixture over and above the rent

recovered/recoverable from the employee and the charges paid or payable for furniture by the employee would be deemed to be the concession in the matter of rent. Therefore, the deemed concession in the matter of rent is Rs.3,125 [i.e. Rs.3,500 (licence fees: 700 x 5) + Rs.4,625 (Value of furniture) – Rs.5,000 (Rs.1,000 × 5)]. Once there is a deemed concession, the provisions of Rule 3(1) would be applicable in computing the taxable perquisite.

Value of the rent free unfurnished accommodation (Rs.700 × 5)	= Rs.3,500
Add: Value of furniture provided by the employer (computed earlier)	= Rs.4,625
Value of rent free furnished accommodation	= Rs.8,125
Less: Rent paid by the employee (Rs.1,000 × 5)	= Rs.5,000
Perquisite value of furnished accommodation given at concessional rent	= Rs.3,125

(3) Valuation of accommodation provided in a hotel: Where the accommodation is provided by the employer (Government or other employer) in a hotel, the value of the perquisite will be lower of:

a. 24% of salary paid or payable for the previous year or

b. the actual charges paid or payable to such hotel for the period during which such accommodation is provided.

The above value is reduced by the rent, if any, actually paid or payable by the employee.

Note: 1. The value of this perquisite will not be calculated if the employee is provided such accommodation for a period not exceeding in aggregate 15 days on the transfer from one place to another.

2. "Hotel" includes licensed accommodation in the nature of motel, service apartment or guest house.

(4) Accommodation provided at the time of transfer:

Where on account of his transfer from one place to another, the employee is provided with accommodation at the new place of posting while retaining the accommodation at the other place, the value of perquisite shall be determined with reference to only one such accommodation which has the lower value (as determined according to the above provisions) for a period not exceeding 90 days and thereafter the value of perquisite shall be charged for both such accommodations in accordance with the valuation rules.

Exceptions:

However, none of the above valuation rules would be applicable to any accommodation provided to an employee working at a mining site/onshore oil exploration site/project execution site/dam site/power generation site/offshore site which, -

(i) being of a temporary nature and having plinth area not exceeding 800 sq. feet, is located at least 8 kms away from the local limits of any municipality or cantonment board; or

(ii) is located in a remote area. [Remote area means an area that is located at least 40 kms away from a town having a population not exceeding 20,000 based on latest published all India census].

Thus, the abovementioned accommodation shall be a tax-free perquisite.

4.26 Income Tax

(5) Motor Car [Sub-rule (2) of Rule 3]

Sl. No.	Circumstances	Where cubic capacity of engine does not exceed 1.6 litres	Where cubic capacity of engine exceeds 1.6 litres
(1)	(2)	(3)	(4)
(1)	Where the motor car is owned or hired by the employer and		
	(a) is used wholly and exclusively in the performance of his official duties;	No value, provided the documents specified in Note 2 below this table are maintained by the employer.	No value, provided the documents specified in Note 2 below this table are maintained by the employer.
	(b) is used exclusively for the private or personal purposes of the employee or any member of his household and the running and maintenance expenses are met or reimbursed by the employer;	Actual amount of expenditure incurred by the employer on the running and maintenance of motor car during the relevant previous year including remuneration, if any, paid by the employer to the chauffeur as increased by the amount representing normal wear and tear of the motor car and as reduced by any amount charged from the employee for such use.	Actual amount of expenditure incurred by the employer on the running and maintenance of motor car during the relevant previous year including remuneration, if any, paid by the employer to the chauffeur as increased by the amount representing normal wear and tear of the motor car and as reduced by any amount charged from the employee for such use.
	(c) is used partly in the performance of duties and partly for private or personal purposes of his own or any member of his household and		
	(i) the expenses on maintenance and running are met or reimbursed by the employer,	Rs.1,200 (plus Rs.600, if chauffeur is also provided to run the motor car)	Rs.1,600 (plus Rs.600, if chauffeur is also provided to run the motor car)

	(ii) the expenses on running and maintenance for such private or personal use are fully met by the assessee.	Rs.400 (plus Rs.600, if chauffeur is provided by the employer to run the motor car)	Rs.600 (plus Rs.600, if chauffeur is also provided to run the motor car)
(2)	Where the employee owns a motor car but the actual running and maintenance charges (including remuneration of the chauffeur, if any) are met or reimbursed to him by the employer and		
	(i) such reimbursement is for the use of the vehicle wholly and exclusively for official purposes,	No value, provided that the documents specified in Note 2 below this table are maintained by the employer.	No value, provided that the documents specified in Note 2 below this table are maintained by the employer.
	(ii) such reimbursement is for the use of the vehicle partly for official purposes and partly for personal or private purposes of the employee or any member of his household.	The actual amount of expenditure incurred by the employer as reduced by Rs.1,200 (plus Rs.600, if chauffeur is also provided to run the motor car). However, the documents specified in Note 2 below this table should be maintained by the employer.	The actual amount of expenditure incurred by the employer as reduced by Rs.1,600 (plus Rs.600, if chauffeur is also provided to run the motor car). However, the documents specified in Note 2 below this table should be maintained by the employer.
(3)	Where the employee owns any other automotive conveyance but the actual running and maintenance charges are met or reimbursed to him by the employer and		
	(i) such reimbursement is for the use of the	No value, provided that the documents specified in Note	Not applicable

	vehicle wholly and exclusively for official purposes,	2 below this table are maintained by the employer.
(ii)	such reimbursement is for the use of the vehicle partly for official purposes and partly for personal or private purposes of the employee.	The actual amount of expenditure incurred by the employer as reduced by an amount of Rs.600, provided the documents specified in Note 2 below this table are maintained by the employer.

Note -

(1) Where one or more motor-cars are owned or hired by the employer and the employee or any member of his household are allowed the use of such motor-car or all or any of such motor-cars (otherwise than wholly and exclusively in the performance of his duties), the value of perquisite shall be the amount calculated in respect of one car in accordance with Sl. No. (1)(c)(i) of the above Table as if the employee had been provided one motor-car for use partly in the performance of his duties and partly for his private or personal purposes and the amount calculated in respect of the other car or cars in accordance with Sl. No. (1)(b) of the above Table as if he had been provided with such car or cars exclusively for his private or personal purposes.

(2) Where the employer or the employee claims that the motor-car is used wholly and exclusively in the performance of official duty or that the actual expenses on the running and maintenance of the motor-car owned by the employee for official purposes is more than the amounts deductible in Sl. No. 2(ii) or 3(ii) of the above Table, he may claim a higher amount attributable to such official use and the value of perquisite in such a case shall be the actual amount of charges met or reimbursed by the employer as reduced by such higher amount attributable to official use of the vehicle provided that the following conditions are fulfilled:

   (a) the employer has maintained complete details of journey undertaken for official purpose which may include date of journey, destination, mileage, and the amount of expenditure incurred thereon;

   (b) the employer gives a certificate to the effect that the expenditure was incurred wholly and exclusively for the performance of official duties.

(3) The normal wear and tear of a motor-car shall be taken at 10 per cent per annum of the actual cost of the motor-car or cars.

(6) Valuation of provision for domestic servants [Sub-rule (3) of Rule 3]

The value of perquisite is determined as under:

Servant appointed by	Servant's salary paid by	Value of perquisite	Taxable in the hands of
Employee	Employee	Nil	Not applicable
Employee	Employer	Actual cost incurred by the employer on the servant	All employees
Employer	Employer	Actual cost incurred by the employer on the servant	Specified employee
Employer	Employee	Nil	Not applicable

Note: Where the employee is paying any amount in respect of such servant facility, the amount so paid shall be deducted from the value of perquisite determined above.

(7) Valuation of supply of gas, electricity or water supplied by employer [Sub-rule (4) of Rule 3]

The value of perquisite is determined as under:

Facility in the name of	Value of perquisite		Taxable in the hands of
	Provided from own source	Provided from outside	
Employee	Manufacturing cost to the employer	Amount paid to the supplier	All employees
Employer	Manufacturing cost to the employer	Amount paid to the supplier	Specified employees

Note: Where the employee is paying any amount in respect of such services, the amount so paid shall be deducted from the value of perquisite determined above.

(8) Valuation of free or concessional educational facilities [Sub-rule (5) of Rule 3]

The value of perquisite is determined as under:

Facility provided to	Value of perquisite		Taxable in the hands of
	Provided in a school owned by the employer	Provided in any other school	
Children	Cost of such education in similar school (There would be no perquisite if the cost of education does	Cost of such education (There would be no perquisite if the cost of education does not	Specified employee

	not exceed Rs.1,000 p.m. per child)	exceed Rs.1,000 p.m. per child)	
Other household member	Cost of such education in similar school	Cost of such education incurred	Specified employee

Note:

1. If the employee incurs the expenditure of school fees and the same is reimbursed by the employer, then the entire amount of reimbursement so made, shall be fully taxable in the hands of all employees.
2. Child includes step child as well as the adopted child of the employee.
3. "Household member" shall include -
   (a) spouse
   (b) children and their spouses
   (c) parents
   (d) servants and dependants.

(9) Free or concessional tickets [Sub-rule (6) of Rule 3]

The value of any benefit or amenity resulting from the provision by an employer engaged in the carriage of passengers or goods to any employee or to any member of his household for personal or private journey free of cost or concessional fare in any conveyance owned, leased or made available by any other arrangement shall be the value at which such benefit or amenity is offered by such employer to the public. Any amount recovered from the employee for such benefit or amenity shall be reduced in determining the value of the perquisite.

However, this sub-rule shall not apply to the employees of an airline or the railways.

(10) Valuation of other fringe benefits and amenities [Sub-rule (7) of Rule 3]

In terms of provisions contained under the erstwhile section 17(2)(vi) **[now section 17(2)(viii)]**, the following other fringe benefits or amenities are hereby prescribed and the value thereof shall be determined in the manner provided hereunder :-

(i) Interest-free or concessional loan [Sub-rule 7(i) of Rule 3]

The value of the benefit to the assessee resulting from the provision of interest-free or concessional loan made available to the employee or any member of his household during the relevant previous year by the employer or any person on his behalf shall be determined as the sum equal to the interest computed at the rate charged per annum by the State Bank of India (SBI) as on the 1st day of the relevant previous year in respect of loans for the same purpose advanced by it. This rate should be applied on the maximum outstanding monthly balance and the resulting amount should be reduced by the interest, if any, actually paid by him or any member of his household.

i.e. value of perquisite = Interest computed as per SBI rates – Interest recovered by the employer from the employee

Notes:

1. Nothing is taxable if such loans are made available for medical treatment in respect of diseases specified in rule 3A of the Income Tax rules or where the amount of loans are petty not exceeding in the aggregate Rs.20,000 .
2. Where loans are made available for medical treatment, referred to above, the exemption shall not apply to so much of the loan as has been reimbursed to the employee under any medical insurance scheme.
3. "Maximum outstanding monthly balance" means the aggregate outstanding balance for each loan as on the last day of each month.

(ii) Travelling, touring and accommodation [Sub-rule 7(ii) of Rule 3]

The value of travelling, touring, stay and other expenses borne by the employer for any holiday availed by the employee or any member of his household shall be the amount of the expenditure incurred by the employer. This provision applies in respect of trips other than those which are exempt under section 10(5) read with Rule 2B. If the facility is maintained by the employer and it is not available uniformly to all employees, the value of benefit shall be taken to be the value at which such facilities are offered by other agencies to the public.

Where the employee is on official tour and the expenses are incurred in respect of any member of his household accompanying him, the amount of expenditure so incurred shall also be a fringe benefit or amenity. However, if the official tour is extended as a vacation, the value of such fringe benefit will be limited to the expenses incurred in relation to such extended period of stay or vacation. The amount so determined shall be reduced by the amount, if any, paid or recovered from the employee for such benefit or amenity.

(iii) Free or concessional food and non-alcoholic beverages [Sub-rule 7(iii) of Rule 3]

The value of free food and non-alcoholic beverages provided by the employer shall be the amount of expenditure incurred by the employer as reduced by the amount, if any, paid or recovered from the employee for such benefit or amenity. However, the following shall not be chargeable as perquisites:

(a) Free food and non-alcoholic beverages provided by the employer during the working hours at office or business premises up to Rs.50 per meal;

(b) Free food and non-alcoholic beverages provided through paid vouchers which are not transferable and usable only at eating joints if the value thereof is up to Rs.50 per meal;

(c) Tea or snacks provided during working hours; and

(d) Free food and non-alcoholic beverages during working hours provided in a remote area or an offshore installation.

(iv) Value of gift, voucher or token in lieu of such gift [Sub-rule 7(iv) of Rule 3]

The value of any gift, or voucher or token in lieu of which such gift may be received by the employee or by member of his household on ceremonial occasions or otherwise from the employer shall be the sum equal to the amount of such gift. If the value of such gift, voucher or token is below Rs. 5,000 in the aggregate during the previous year, the value of perquisite shall be taken as nil.

(v) Credit card expenses [Sub-rule 7(v) of Rule 3]

The amount of expenses including membership fees and annual fees incurred by the employee or any member of his household which is charged to a credit card (including add-on-card) provided by the employer or otherwise, paid for or reimbursed by the employer shall be taken to be the value of perquisite chargeable to tax. The amount so determined shall be reduced by the amount, if any, paid or recovered from the employee for such benefit or amenity. However, such expenses incurred wholly and exclusively for official purposes would not be treated as a perquisite if the following conditions are satisfied:

(a) complete details in respect of such expenditure are maintained by the employer which may, inter alia, include the date of expenditure and the nature of expenditure;

(b) the employer gives the certificate for such expenditure to the effect that the same was incurred wholly and exclusively for the performance of official duties;

(vi) Club expenditure [Sub-rule 7(vi) of Rule 3]

If employer reimburses or makes payment of any expenditure incurred in a club including the amount of annual or periodical fee for the employee or any member of household, the actual amount of such expenditure shall be the value of perquisite. The amount so determined shall be reduced by the amount, if any, paid or recovered from the employee for such benefit or amenity. Where the employer has obtained corporate membership of the club and the facility is enjoyed by the employee or any member of his household, the value of perquisite shall not include the initial fee paid for acquiring such corporate membership.

If the employer provides uniformly to all employees the use of health club, sports and similar facilities, there will be no taxable perquisite in respect of such facilities. Besides, there will be no taxable perquisite if the club expenditure is incurred wholly and exclusively for business purposes and the following conditions are fulfilled:

(a) complete details in respect of such expenditure are maintained by the employer which may, *inter alia*, include the date of expenditure and the nature of expenditure and its business expediency;

(b) the employer gives a certificate for such expenditure to the effect that the same was incurred wholly and exclusively for the performance of official duties.

(vii) Use of moveable assets [Sub-rule 7(vii) of Rule 3]

Value of perquisite is determined as under:

Asset given		Value of benefit	
(a)	Use of laptops and computers	Nil	
(b)	Movable assets, other than		
	(i) laptops and computers; and	(i)	10% p.a. of the actual cost of such asset, or
	(ii) assets already specified	(ii)	the amount of rent or charge paid, or payable by the employer as the case may be

Note: Where the employee is paying any amount in respect of such asset, the amount so paid shall be deducted from the value of perquisite determined above.

(viii) Transfer of moveable assets [Sub-rule 7(viii) of Rule 3]

Value of perquisite is determined as under:

Assets transferred	Value of perquisite
Computers and electronic items	Depreciated value of asset [depreciation is computed @ 50% on WDV for each completed year of usage]
Motor cars	Depreciated value of asset [depreciation is computed @ 20% on WDV for each completed year of usage]
Any other asset	Depreciated value of asset [depreciation is computed @ 10% on SLM for each completed year of usage]

Note: Where the employee is paying any amount in respect of such asset, the amount so paid shall be deducted from the value of perquisite determined above.

(ix) Other benefit or amenity [Sub-rule 7(ix) of Rule 3]

The value of any other benefit or amenity, service, right or privilege provided by the employer shall be determined on the basis of cost to the employer under an arms' length transaction as reduced by the employee's contribution, if any. However, there will be no taxable perquisite in respect of expenses on telephones including mobile phone actually incurred on behalf of the employee by the employer i.e., if an employer pays or reimburses telephone bills or mobile phone charges of employee, there will be no taxable perquisite.

Note – The new perquisite valuation rules would be notified by the CBDT consequent to withdrawal of Fringe Benefit Tax. Since the new rules have not been notified up to 31st October, 2009, they would not be applicable for May 2010 examination, even if they are subsequently notified with retrospective effect. When such rules are notified, they would be hosted on the website of the Institute www.icai.org and would be made applicable for November 2010 examination. The new rules would also be given in the Revision Test Paper for November 2010 examination.

4.34 Income Tax

Rule 3(7), providing for valuation of "other fringe benefits and amenities" is based on the terms of the provisions contained in the erstwhile clause (vi) of section 17(2). The Finance (No.2) Act, 2009 has amended section 17(2) by including certain other perquisites under clauses (vi) and (vii) of section 17(2). Consequently, the residual clause, namely, clause (viii) of section 17(2), now provides for taxing the value of any other fringe benefit or amenity as may be prescribed. However, since the new perquisite rules are yet to be notified, therefore, Rule 3(7), prescribing the fringe benefits or amenities in terms of the erstwhile clause (vi) [now clause (viii)] of section 17(2) have been given in this study material and would be applicable for May 2010 examination.

(11) Medical facilities

The following medical facilities will not amount to a perquisite:

(i) The value of any medical treatment provided to an employee or any member of his family in any hospital maintained by the employer;

(ii) Any sum paid by the employer in respect of any expenditure actually incurred by the employee on his medical treatment or treatment of any member of his family in any hospital maintained by the Government/local authority/any other hospital approved by the Government for the purpose of medical treatment of its employees;

(iii) Any sum paid by the employer in respect of any expenditure actually incurred by the employee on his medical treatment or treatment of any member of his family in respect of the prescribed disease or ailments in any hospital approved by the Chief Commissioner having regard to the prescribed guidelines. However, in order to claim this benefit, the employee shall attach with his return of income a certificate from the hospital specifying the disease or ailment for which medical treatment was required and the receipt for the amount paid to the hospital.

Thus, the two types of facilities are covered:

(a) payment by the employer for treatment in a Government hospital and

(b) payment by an employer for treatment of prescribed diseases in any hospital approved by the Chief Commissioner.

(iv) Any premium paid by an employer in relation to an employee to effect an insurance on the health of such employee. However, any such scheme should be approved by the Central Government or the Insurance Regulatory Development Authority (IRDA) for the purposes of section 36(1)(ib).

(v) Any sum paid by the employer in respect of any premium paid by the employee to effect an insurance on his family under any scheme approved by the Central Government for the purposes of section 80D.

(vi) Any sum paid by the employer in respect of any expenditure actually incurred by the employee on his medical treatment or treatment of any member of his family to the extent of Rs.15,000 in the previous year.

Note: It is important to note that this expenditure need not be incurred either in the government hospital or in a hospital approved by the Chief Commissioner.

(vii) Any expenditure incurred by the employer on the following:

(a) medical treatment of the employee or any member of the family of such employee outside India;

(b) travel and stay abroad of the employee or any member of the family of such employee for medical treatment;

(c) travel and stay abroad of one attendant who accompanies the patient in connection with such treatment.

Conditions:

1. The perquisite element in respect of expenditure on medical treatment and stay abroad will be exempt only to the extent permitted by the RBI.
2. The expenses in respect of traveling of the patient and the attendant will be exempt if the employee's gross total income as computed before including the said expenditure does not exceed Rs.2 lakh.

   Note: For this purpose, family means spouse and children of the individual. Children may be dependant or independent, married or unmarried. It also includes parents, brothers and sisters of the individual if they are wholly or mainly dependant upon him.

Illustration 9

Compute the taxable value of the perquisite in respect of medical facilities received by Mr. G from his employer during the P.Y.2009-10:

Medical premium paid for insuring health of Mr. G	Rs.7,000
Treatment of Mr. G by his family doctor	Rs.5,000
Treatment of Mrs. G in a Government hospital	Rs.25,000
Treatment of Mr. G's grandfather in a private clinic	Rs.12,000
Treatment of Mr. G's mother (68 years and dependant) by family doctor	Rs.8,000
Treatment of Mr. G's sister (dependant) in a nursing home	Rs.3,000
Treatment of Mr. G's brother (independent)	Rs.6,000
Treatment of Mr. G's father (75 years and dependant) abroad	Rs.50,000
Expenses of staying abroad of the patient and attendant	Rs.30,000

Limit specified by RBI Rs.75,000

Solution

Computation of taxable value of perquisite in the hands of Mr. G

Particulars	Rs.	Rs.
Treatment of Mrs. G in a Government hospital		-
Treatment of Mr. G's father (75 years and dependant) abroad	50,000	

Expenses of staying abroad of the patient and attendant	30,000	
	80,000	
Less : Exempt up to limit specified by RBI	75,000	5,000
Medical premium paid for insuring health of Mr. G		-
Treatment of Mr. G by his family doctor	5,000	
Treatment of Mr. G's mother (dependant) by family doctor	8,000	
Treatment of Mr. G's sister (dependant) in a nursing home	3,000	
	16,000	
Less: Exempt upto Rs.15,000	15,000	1,000
Add: Treatment of Mr. G's grandfather in a private clinic		12,000
Add: Treatment of Mr. G's brother (independent)		6,000
Taxable value of perquisite		24,000

Note: Grandfather and independent brother are not included within the meaning of family of Mr. G.

(12) Payment of premium on personal accident insurance policies

If an employer takes personal accident insurance policies on the lives of employees and pays the insurance premium, no immediate benefit would become payable and benefit will accrue at a future date only if certain events take place.

Moreover, the employers would be taking such policy in their business interest only, so as to indemnify themselves from payment of any compensation. Therefore, the premium so paid will not constitute taxable perquisites in the employees' hands - *CIT vs. Lala Shri Dhar [1972] 84 ITR 19 (Del.).*

4.21 DEDUCTIONS FROM SALARY

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

(1) Entertainment allowance [section 16(ii)]

(2) Professional tax [section 16(iii)]

(1) Entertainment allowance:

Entertainment allowance received is fully taxable and is first to be included in the salary and thereafter the following deduction is to be made:

However deduction in respect of entertainment allowance is available in case of Government employees. The amount of deduction will be lower of:

i. One-fifth of his basic salary or

ii. Rs.5,000 or

iii. Entertainment allowance received.

Deduction is permissible even if the amount received as entertainment allowance is not proved to have been spent - *CIT vs. Kamal Devi [1971] 81 ITR 773 (Delhi).*

Amount actually spent by the employee towards entertainment out of the entertainment allowance received by him is not a relevant consideration at all.

(2) Professional tax on employment:

Professional tax or taxes on employment levied by a State under Article 276 of the Constitution is allowed as deduction only when it is actually paid by the employee during the previous year.

If professional tax is reimbursed or directly paid by the employer on behalf of the employee, the amount so paid is first included as salary income and then allowed as a deduction under section 16.

Illustration 10

Mr. Goyal receives the following emoluments during the previous year ending 31.03.10.

Basic pay	Rs.40,000
Dearness Allowance	Rs.15,000
Commission	Rs.10,000
Entertainment allowance	Rs.4,000
Medical expenses reimbursed	Rs.25,000
Professional tax paid	Rs.3,000 (Rs.2,000 was paid by his employer)

Mr. Goyal contributes Rs.5000 towards recognized provident fund. He has no other income. Determine the income from salary for A.Y. 2010-11, if Mr. Goyal is a State Government employee.

Solution

Computation of salary of Mr. Goyal for the A.Y. 2010-11

Particulars	Rs.	Rs.
Basic Salary		40,000
Dearness Allowance		15,000
Commission		10,000
Entertainment Allowance received		4,000
Employee's contribution to RPF [Note]		-
Medical expenses reimbursed	25,000	
Less : Exempt medical expenses	15,000	10,000
Professional Tax paid by the employer		2,000
Gross Salary		**81,000**

4.38 Income Tax

Less: Deductions		
under section 16(ii) Entertainment allowance being lower of :		
(a) Allowance received	4,000	
(b) One fifth of basic salary [1/5 × 40,000]	8,000	
(c) Statutory amount	5,000	4,000
- under section 16(iii) Professional Tax paid		3,000
Income from Salary		**74,000**

Note: Employee's contribution to RPF is not taxable. It is eligible for deduction under section 80C.

4.22 DEDUCTION UNDER SECTION 80C

Under the provisions of section 80C, an assessee will be entitled to a deduction from gross total income of the amount invested in LIC policies, provident funds, payment of tuition fees, repayment of housing loans, investment in infrastructure bonds etc. subject to a maximum of Rs.1,00,000.

Students may refer to Chapter 7 on 'Deduction from Gross Total Income' for a detailed discussion.

4.23 RELIEF UNDER SECTION 89

(1) Where by reason of any portion of an assessee's salary being paid in arrears or in advance or by reason of his having received in any one financial year, salary for more than twelve months or a payment of profit in lieu of salary under section 17(3), his income is assessed at a rate higher than that at which it would otherwise have been assessed, the Assessing Officer shall, on an application made to him in this behalf, grant such relief as prescribed. The procedure for computing the relief is given in rule 21A.

(2) Similar tax relief is extended to assessees who receive arrears of family pension as defined in the *Explanation* to clause (iia) of section 57. For the purpose of clause (iia) of section 57, "family pension" means a regular monthly amount payable by the employer to a person belonging to the family of an employee in the event of his death.

(3) No relief shall be granted in respect of any amount received or receivable by an assessee on his voluntary retirement or termination of his service, in accordance with any scheme or schemes of voluntary retirement or a scheme of voluntary separation (in the case of a public sector company), if exemption under section 10(10C) in respect of such compensation received on voluntary retirement or termination of his service or voluntary separation has been claimed by the assessee in respect of the same assessment year or any other assessment year.

Illustration 11

In the case of Mr. Hari, you are informed that the salary for the previous year 2009-10 is Rs.6,20,000 and arrears of salary received is Rs.80,000. Further, you are given the following details relating to the earlier years to which the arrears of salary received is attributable to:

Previous year	Taxable Salary	Arrears now received (Rs.)
2000 - 2001	75,000	15,000
2001 - 2002	80,000	25,000
2002 - 2003	90,000	40,000

Compute the relief available under section 89 of the Income-tax Act and the tax payable for the A.Y. 2010-11.

Note 1:

a) Rates of Taxes:

For A.Y. 2001-02; 2002-03 & 2003-04

Upto 50,000 – Nil; 50,000 to 60,000 – 10% ;

60,001 to 1,50,000 – 20% ; above 1,50,000 –30%

b) Surcharge:

A.Y. 2001-02	-12% (if total income exceeds Rs.60,000)
	-17% (if total income exceeds Rs.1,50,000)
A.Y. 2002-03	- 2% (if total income exceeds Rs.60,000)
A.Y. 2003-04	- 5% (if total income exceeds Rs.60,000)

Solution

Computation of tax payable by Mr. Hari for the A.Y 2010-11

Particulars	Incl. arrears of salary	Excl. arrears of salary
Current year salary	6,20,000	6,20,000
Add: Arrears of salary	80,000	
Taxable Salary	7,00,000	6,20,000
Income-tax thereon	1,14,000	90,000
Add : Education cess @ 2% plus secondary and higher education cess @1%	3,420	2,700
Total payable	**1,17,420**	**92,700**

Computation of tax payable on arrears of salary if charged to tax in the respective assessment years

Particulars	A.Y. 2001-02		A.Y. 2002-03		A.Y. 2003-04	
	Incl. arrears	Excl. arrears	Incl. arrears	Excl. arrears	Incl. arrears	Excl. arrears
Taxable salary	75,000	75,000	80,000	80,000	90,000	90,000
Add: Arrears of salary	15,000	---	25,000	---	40,000	---
Taxable salary	90,000	75,000	1,05,000	80,000	1,30,000	90,000
Tax on the above	7,000	4,000	10,000	5,000	15,000	7,000
Add: Surcharge	840	480	200	100	750	350
Tax payable	**7,840**	**4,480**	**10,200**	**5,100**	**15,750**	**7,350**

Computation of relief under section 89

	Particulars	Rs.	Rs.
i)	Tax payable in A.Y. 2010-11 on arrears :		
	Tax on income including arrears	1,17,420	
	Less : Tax on income excluding arrears	92,700	24,720
ii)	Tax payable in respective years on arrears :		
	Tax on income including arrears (Rs.7,840+Rs.10,200+Rs.15,750)	33,790	
	Less : Tax on income excluding arrears (Rs.4,480+Rs.5,100+Rs.7,350)	16,930	16,860
	Relief under section 89 - difference between tax on arrears in A.Y 2010-11 and tax on arrears in the respective years		**7,860**

Tax payable for A.Y 2010-11 after relief under section 89

Particulars	Rs.
Income-tax payable on total income including arrears of salary	1,17,420
Less : Relief under section 89 as computed above	7,860
Tax payable after claiming relief	**1,09,560**

Illustration 12

Mr. X is employed with AB Ltd. on a monthly salary of Rs.25,000 per month and an entertainment allowance and commission of Rs.1,000 p.m. each. The company provides him with the following benefits:

1. A company owned accommodation is provided to him in Delhi. Furniture costing Rs.2,40,000 was provided on 1.8.2009.
2. A personal loan of Rs.5,00,000 on 1.7.2009 on which it charges interest @ 6.75% p.a. The entire loan is still outstanding. (Assume SBI rate of interest to be 12.75% p.a.)
3. His son is allowed to use a motor cycle belonging to the company. The company had purchased this motor cycle for Rs.60,000 on 1.5.2006. The motor cycle was finally sold to him on 1.8.2009 for Rs.30,000.
4. Mr. X is provided with free electricity. Cost to the employer is Rs.10,000
5. Professional Tax paid by Mr. X is Rs.2,000.

Compute the income from salary of Mr. X for the A.Y.2010-11.

Solution

Computation of Income from Salary of Mr. X for the A.Y. 2010-11

Particulars	Rs.	Rs.
Basic Salary [Rs.25,000 × 12]		3,00,000
Commission [Rs.1,000 × 12]		12,000
Entertainment Allowance [Rs.1,000 × 12]		12,000
Rent free accommodation [Note 1]	48,600	
Add : Value of furniture [Rs.2,40,000 × 10% p.a. for 8 months]	16,000	64,600
Interest on Personal loan [Note 2]		22,500
Use of motor cycle [Rs.60,000 × 10% p.a. for 4 months]		2,000
Transfer of motor cycle [Note 3]		12,000
Free electricity facility [Note 4]		10,000
Gross Salary		**4,35,100**
Less : Deductions		
- under section 16(iii) Professional Tax paid		2,000
Income from Salary		**4,33,100**

Note 1: Value of rent free unfurnished accommodation

= 15% of salary for the relevant period

= 15% of (Rs.3,00,000 + Rs.12,000 + Rs.12,000)

= Rs.48,600

Note 2: SBI rate of Interest on personal loan = 12.75% p.a.

Value of perquisite for interest on personal loan

= [Rs.5,00,000 × (12.75% - 6.75%) for 9 months] = Rs.22,500

Note 3: Depreciated value of the motor cycle

= Original cost – Depreciation @ 10% p.a. for 3 completed years.

= Rs.60,000 – (Rs.60,000 × 10% p.a. × 3 years)

= Rs.42,000.

Perquisite = Rs.42,000 – Rs.30,000 = Rs.12,000.

Note 4: Free electricity facility provided to the employee will be taxable only if he is a specified employee. Salary for the purpose of specified employee is -

= Rs. [3,00,000 + 12,000 + 12,000 – 2,000]

= Rs.3,22,000 > Rs.50,000 p.a.

He is a specified employee and so electricity facility is taxable.

Self-examination questions

1. Define "Salary" and discuss the basis of charge of salary.
2. Distinguish between foregoing of salary and surrender of salary.
3. Write short notes on -
   a) Profits in lieu of salary
   b) Specified employees
4. Is retrenchment compensation received by workmen taxable under the Act? If yes, to what extent is it taxable?
5. When is provision of medical facilities or assistance by an employer not treated as a perquisite in the hands of the employee? Discuss.
6. Discuss whether the tax paid by the employer, on the non-monetary perquisites provided to its employees, constitutes an income in the hands of the employees.
7. Anirudh was working as a regional sales manager of a company. He was paid salary plus commission based on volume of sales effected by him. Anirudh claimed that the expenses incurred by him for earning the commission should be allowed as a deduction. Discuss the validity of his claim.

Answer

7. On this question the Madras High Court, in *CIT v. R. Rajendran (2004) 135 Taxman 95,* opined that since the assessee was employed as a regional sales manager and since commission paid to the assessee was with reference to the volume of sales, such commission was obviously to encourage the employee to effect a higher volume of sales. The commission so paid in addition to what the employer had fixed as a salary would also form part of salary and hence no deduction was allowable in respect of any expenditure incurred to earn the commission.

Therefore, in this case, it can be inferred that Anirudh's claim is not valid.

5

INCOME FROM HOUSE PROPERTY

5.1 CHARGEABILITY [SECTION 22]

(i) The process of computation of income under the head "Income from house property" starts with the determination of annual value of the property. The concept of annual value and the method of determination is laid down in section 23.

(ii) The annual value of any property comprising of building or land appurtenant thereto, of which the assessee is the owner, is chargeable to tax under the head "Income from house property".

5.2 CONDITIONS FOR CHARGEABILITY

(i) Property should consist of any building or land appurtenant thereto.

(a) Buildings include not only residential buildings, but also factory buildings, offices, shops, godowns and other commercial premises.

(b) Land appurtenant means land connected with the building like garden, garage etc.

(c) Income from letting out of vacant land is, however, taxable under the head "Income from other sources".

(ii) Assessee must be the owner of the property

(a) Owner is the person who is entitled to receive income from the property in his own right.

(b) The requirement of registration of the sale deed is not warranted.

(c) Ownership includes both free-hold and lease-hold rights.

(d) Ownership includes deemed ownership (discussed later in para 2.12)

(e) The person who owns the building need not also be the owner of the land upon which it stands.

(f) The assessee must be the owner of the house property during the previous year. It is not material whether he is the owner in the assessment year.

5.2 Income Tax

(g) If the title of the ownership of the property is under dispute in a court of law, the decision as to who will be the owner chargeable to income-tax under section 22 will be of the Income-tax Department till the court gives its decision to the suit filed in respect of such property.

(iii) The property may be used for any purpose, but it should not be used by the owner for the purpose of any business or profession carried on by him, the profit of which is chargeable to tax.

(iv) Property held as stock-in-trade etc.

Annual value of house property will be charged under the head "Income from house property" in the following cases also –

(a) Where it is held by the assessee as stock-in-trade of a business;

(b) Where the assessee is engaged in the business of letting out of property on rent;

Exceptions

(a) Letting out is supplementary to the main business

(i) Where the property is let out with the object of carrying on the business of the assessee in an efficient manner, then the rental income is taxable as business income, provided letting is not the main business but it is supplementary to the main business.

(ii) In such a case, the letting out of the property is supplementary to the main business of the assessee and deductions/allowances have to be calculated as relating to profits/gains of business and not relating to house property.

(b) Letting out of building along with other facilities

(i) Where income is derived from letting out of building along with other facilities like furniture, the income cannot be said to be derived from mere ownership of house property but also because of facilities and services rendered and hence assessable as income from business.

(ii) Where a commercial property is let out along with machinery e.g. a cotton mill including the building and the two lettings are inseparable, the income will either be assessed as business income or as income from other sources, as the case may be.

5.3 COMPOSITE RENT

(i) Meaning of composite rent

The owner of a property may sometimes receive rent in respect of building as well as –

(1) other assets like say, furniture, plant and machinery.

(2) for different services provided in the building, for eg. –

(a) Lifts;

(b) Security;

(c) Power backup;

The amount so received is known as "composite rent".

(ii) Tax treatment of composite rent

(1) Where composite rent includes rent of building and charges for different services (lifts, security etc.), the composite rent is has to be split up in the following manner -

(a) the sum attributable to use of property is to be assessed under section 22 as income from house property;

(b) the sum attributable to use of services is to charged to tax under the head "Profits and gains of business or profession" or under the head "Income from other sources".

(2) Where composite rent is received from letting out of building and other assets (like furniture) and the two lettings are not separable –

(a) If the letting out of building and other assets are not separable i.e. the other party does not accept letting out of buildings without other assets, then the rent is taxable either as business income or income from other sources;

(b) This is applicable even if sum receivable for the two lettings is fixed separately.

(3) Where composite rent is received from letting out of buildings and other assets and the two lettings are separable –

(a) If building is let out along with other assets, but the two lettings are separable i.e. letting out of one is acceptable to the other party without letting out of the other, then income from letting out of building is taxable under "Income from house property";

(b) Income from letting out of other assets is taxable as business income or income from other sources;

(c) This is applicable even if a composite rent is received by the assessee from his tenant for the two lettings.

5.4 INCOME FROM HOUSE PROPERTY SITUATED OUTSIDE INDIA

(i) In case of a resident in India (resident and ordinarily resident in case of individuals and HUF), income from property situated outside India is taxable, whether such income is brought into India or not.

(ii) In case of a non-resident or resident but not ordinarily resident in India, income from a property situated outside India is taxable only if it is received in India.

5.5 DETERMINATION OF ANNUAL VALUE [SECTION 23]

This involves three steps :

Step 1 - Determination of Gross Annual Value (GAV).

Step 2 – From the gross annual value computed in step 1, deduct municipal tax paid by the owner during the previous year.

5.4 Income Tax

Step 3 – The balance will be the Net Annual Value (NAV), which as per the Income-tax Act is the annual value.

(i) Determination of annual value for different types of house properties

(1) Where the property is let out throughout the previous year [Section 23(1)(a)/(b)]

Where the property is let out for the whole year, then the GAV would be the higher of -

(a) Annual Letting Value (ALV) and

(b) Actual rent received or receivable during the year

- The ALV is the higher of fair rent (FR) and municipal value (MV), but restricted to standard rent (SR).

  For example, let us say the higher of FR and MV is X. Then ALV = SR, if X>SR. However, if X<SR, ALV = X.
- ALV as per section 23(1)(a) cannot exceed standard rent (SR) but it can be lower than standard rent, in a case where standard rent is more than the higher of MV and FR.

- Municipal value is the value determined by the municipal authorities for levying municipal taxes on house property.
- Fair rent means rent which similar property in the same locality would fetch.
- The standard rent is fixed by the Rent Control Act.
- From the GAV computed above, municipal taxes paid by the owner during the previous year is to be deducted to arrive at the NAV.

Illustration 1

Jayashree owns five houses in Chennai, all of which are let-out. Compute the GAV of each house from the information given below –

Particulars	House I	House II	House III	House IV	House V
Municipal Value	80,000	55,000	65,000	24,000	75,000
Fair Rent	90,000	60,000	65,000	25,000	80,000
Standard Rent	N.A.	75,000	58,000	N.A.	78,000
Actual rent received/ receivable	72,000	72,000	60,000	30,000	72,000
Solution					
GAV	90,000	72,000	60,000	30,000	78,000

(2) Where let out property is vacant for part of the year [Section 23(1)(c)]

Where let out property is vacant for part of the year and owing to vacancy, the actual rent is lower than the ALV, then the actual rent received or receivable will be the GAV of the property.

(3) In case of self-occupied property or unoccupied property [Section 23(2)]

(a) Where the property is self-occupied for own residence or unoccupied throughout the previous year, its Annual Value will be Nil, provided no other benefit is derived by the owner from such property.

(b) The benefit of exemption of one self-occupied house is available only to an individual/HUF.

(c) The expression "Unoccupied property" refers to a property which cannot be occupied by the owner by reason of his employment, business or profession at a different place and he resides at such other place in a building not belonging to him.

(d) No deduction for municipal taxes is allowed in respect of such property.

(4) Where a house property is let-out for part of the year and self-occupied for part of the year [Section 23(3)]

(a) If a single unit of a property is self-occupied for part of the year and let-out for the remaining part of the year, then the ALV for the whole year shall be taken into account for determining the GAV.

(b) The ALV for the whole year shall be compared with the actual rent for the let out period and whichever is higher shall be adopted as the GAV.

(c) However, property taxes for the whole year is allowed as deduction provided it is paid by the owner during the previous year.

(5) In case of deemed to be let out property [Section 23(4)]

(a) Where the assessee owns more than one property for self-occupation, then the income from any one such property, at the option of the assessee, shall be computed under the self-occupied property category and its annual value will be nil. The other self-occupied/unoccupied properties shall be treated as "deemed let out properties".

(b) This option can be changed year after year in a manner beneficial to the assessee.

(c) In case of deemed let-out property, the ALV shall be taken as the GAV.

(d) The question of considering actual rent received/receivable does not arise. Consequently, no adjustment is necessary on account of property remaining vacant or unrealized rent.

(e) Municipal taxes actually paid by the owner during the previous year can be claimed as deduction.

(6) In case of a house property, a portion let out and a portion self-occupied

(a) Income from any portion or part of a property which is let out shall be computed

separately under the "let out property" category and the other portion or part which is self-occupied shall be computed under the "self-occupied property" category.

(b) There is no need to treat the whole property as a single unit for computation of income from house property.

(c) Municipal valuation/fair rent/standard rent, if not given separately, shall be apportioned between the let-out portion and self-occupied portion either on plinth area or built-up floor space or on such other reasonable basis.

(d) Property taxes, if given on a consolidated basis can be bifurcated as attributable to each portion or floor on a reasonable basis.

Notional income instead of real income

Thus, under this head of income, there are circumstances where notional income is charged to tax instead of real income. For example –

- Where the assessee owns more than one house property for the purpose of self-occupation, the annual value of any one of those properties, at the option of the assessee, will be nil and the other properties are deemed to be let-out and income has to be computed on a notional basis by taking the ALV as the GAV.
- In the case of let-out property also, if the ALV exceeds the actual rent, the ALV is taken as the GAV.

(ii) Treatment of unrealised rent [*Explanation* to section 23(1)]

(1) The Actual rent received/receivable should not include any amount of rent which is not capable of being realised.

(2) However the conditions prescribed in Rule 4 should be satisfied. They are –

(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 satisfies the Assessing Officer that legal proceedings would be useless.

(iii) Property taxes (Municipal taxes)

(1) Property taxes are allowable as deduction from the GAV subject to the following two conditions:

(a) It should be borne by the assessee (owner); and

(b) It should be actually paid during the previous year.

(2) If property taxes levied by a local authority for a particular previous year is not paid during that year, no deduction shall be allowed in the computation of income from house property for that year.

(3) However, if in any subsequent year the arrears are paid, then the amount so paid is allowed as deduction in computation of income from house property for that year.

(4) Thus, we find that irrespective of the previous year in which the liability to pay such taxes arise according to the method of accounting regularly employed by the owner, the deduction in respect of such taxes will be allowed only in the year of actual payment.

(5) In case of property situated outside India, taxes levied by local authority of the country in which the property is situated is deductible. *[CIT v. R. Venugopala Reddiar* (1965) 58 ITR 439 (Mad).*]*

Illustration 2

Rajesh, a British national, is a resident and ordinarily resident in India during the P.Y.2009-10. He owns a house in London, which he has let out at £ 10,000 p.m. The muncipal taxes paid to the Municipal Corporation of London is £ 8,000 during the P.Y.2009-10. The value of one £ in Indian rupee to be taken at Rs.82.50. Compute Rajesh's taxable income for the A.Y. 2010-11.

Solution

For the P.Y.2009-10, Mr. Rajesh, a British national, is resident and ordinarily resident in India. Therefore, income received by him by way of rent of the house property located in London is to be included in the total income in India. Municipal taxes paid in London is be to allowed as deduction from the gross annual value.

Computation of Income from house property of Mr. Rajesh for A.Y.2010-11

Particulars	**Rs.**
Gross Annual Value (*£ 10,000 × 12 × 82.50)*	99,00,000
Less: Municipal taxes paid (*£ 8,000 × 82.50)*	6,60,000
Net Annual Value (NAV)	**92,40,000**
Less: Deduction u/s 24	
(a) 30% of NAV = 30% of Rs.92,40,000	27,72,000
Income from house property	**64,68,000**

5.6 DEDUCTIONS FROM ANNUAL VALUE [SECTION 24]

(i) There are two deductions from annual value. They are –

(1) 30% of NAV; and

(2) interest on borrowed capital

5.8 Income Tax

(1) 30% of NAV is allowed as deduction under section 24(a)

(a) This is a flat deduction and is allowed irrespective of the actual expenditure incurred.

(b) In case of self-occupied property where the annual value is nil, the assessee will not be entitled to deduction of 30%, as the annual value itself is nil.

(2) Interest on borrowed capital is allowed as deduction under section 24(b)

(a) Interest payable on loans borrowed for the purpose of acquisition, construction, repairs, renewal or reconstruction can be claimed as deduction.

(b) Interest payable on a fresh loan taken to repay the original loan raised earlier for the aforesaid purposes is also admissible as a deduction.

(c) Interest relating to the year of completion of construction can be fully claimed in that year irrespective of the date of completion.

(d) Interest payable on borrowed capital for the period prior to the previous year in which the property has been acquired or constructed, can be claimed as deduction over a period of 5 years in equal annual installments commencing from the year of acquisition or completion of construction.

Illustration 3

Arvind had taken a loan of Rs.5,00,000 for construction of property on 1.10.2008. Interest was payable @ 10% p.a. The construction was completed on 30.6.2009. No principal repayment has been made up to 31.3.2010. Compute the interest allowable as deduction under section 24 for the A.Y.2010-11.

Solution

Interest for the year (1.4.09 to 31.3.10) = 10% of Rs.5,00,000 = Rs.50,000

Pre-construction interest = 10% of Rs.5,00,000 for 6 months (from 1.10.08 to 31.3.09) = 25,000

Pre-construction interest to be allowed in 5 equal annual installments of Rs.5,000 from the year of completion of construction i.e. in this case, P.Y.2009-10.

Therefore, total interest deduction under section 24 = 50,000+5000 = Rs.55,000.

(ii) Deduction in respect of one self-occupied property where annual value is nil

(1) In this case, the assessee will be allowed a deduction on account of interest (including $1/5^{th}$ of the accumulated interest of pre-construction period) as under –

(a)	Where the property has been acquired, constructed, repaired, renewed or reconstructed with borrowed capital before 1.4.99.	Actual interest payable subject to maximum of Rs.30,000.

(b)	Where the property is acquired or constructed with capital borrowed on or after 1.4.99 and such acquisition or construction is completed within 3 years from the end of the financial year in which the capital was borrowed.	Actual interest payable subject to maximum of Rs.1,50,000, if certificate mentioned in (2) below is obtained.
(c)	Where the property is repaired, renewed or reconstructed with capital borrowed on or after 1.4.99.	Actual interest payable subject to a maximum of Rs.30,000.

(2) For the purpose of claiming deduction of Rs.1,50,000 as per 1(b) in the table given above, the assessee should furnish a certificate from the person to whom any interest is payable on the capital borrowed, specifying the amount of interest payable by the assessee for the purpose of such acquisition or construction of the property.

(3) The ceiling prescribed for one self-occupied property as above in respect of interest on loan borrowed does not apply to a deemed let-out property.

(4) Deduction under section 24(b) for interest is available on accrual basis. Therefore interest accrued but not paid during the year can also be claimed as deduction.

(5) Where a buyer enters into an arrangement with a seller to pay the sale price in installments along with interest due thereon, the seller becomes the lender in relation to the unpaid purchase price and the buyer becomes the borrower. In such a case, unpaid purchase price can be treated as capital borrowed for acquiring property and interest paid thereon can be allowed as deduction under section 24.

(6) Interest on unpaid interest is not deductible.

5.7 COMPUTATION OF INCOME FROM HOUSE PROPERTY FOR DIFFERENT CATEGORIES OF PROPERTY

(i) Property let out throughout the previous year

PARTICULARS		Amount
Computation of GAV		
Step 1	Compute ALV	
	ALV = Higher of MV and FR, but restricted to SR	
Step 2	Compute Actual rent received/receivable	
	Actual rent received/receivable less unrealized rent as per Rule 4	
Step 3	Compare ALV and Actual rent received/receivable	
Step 4	GAV is the higher of ALV and Actual rent received/receivable	
Gross Annual Value (GAV)		A
Less:	Municipal taxes (paid by the owner during the previous year)	B

5.10 Income Tax

Net Annual Value (NAV) = (A-B)			C
Less:	**Deductions u/s 24**		
	(a) 30% of NAV	D	
	(b) Interest on borrowed capital (actual without any ceiling limit)	E	
Income from house property (C-D-E)			F

Illustration 4

Anirudh has a property whose municipal valuation is Rs.1,30,000 p.a. The fair rent is Rs.1,10,000 p.a. and the standard rent fixed by the Rent Control Act is Rs.1,20,000 p.a. The property was let out for a rent of Rs.11,000 p.m. throughout the previous year. Unrealised rent was Rs.11,000 and all conditions prescribed by Rule 4 are satisfied. He paid municipal taxes @10% of municipal valuation. Interest on borrowed capital was Rs.40,000 for the year. Compute the income from house property of Anirudh.

Solution

Computation of Income from house property of Mr. Anirudh for A.Y. 2009-10

Particulars		**Amount in Rs.**	
Computation of GAV			
Step 1	Compute ALV		
	ALV = Higher of MV of Rs.1,30,000 p.a. and FR of Rs.1,10,000 p.a., but restricted to SR of Rs.1,20,000 p.a.	1,20,000	
Step 2	Compute actual rent received/receivable		
	Actual rent received/receivable less unrealized rent as per Rule 4 = 1,32,000-11,000	1,21,000	
Step 3	Compare ALV of Rs.1,20,000 and Actual rent received/receivable of Rs.1,21,000.		
Step 4	GAV is the higher of ALV and Actual rent received/receivable	1,21,000	
Gross Annual Value (GAV)			**1,21,000**
Less:	Municipal taxes (paid by the owner during the previous year) = 10% of Rs.1,30,000		13,000
Net Annual Value (NAV) = 1,21,000-13,000			**1,08,000**

Less:	**Deductions u/s 24**		
	(a) 30% of NAV	32,400	
	(b) Interest on borrowed capital		
	(actual without any ceiling limit)	40,000	72,400
Income from house property (1,08,000-32,400-40,000)			**35,600**

(ii) Let out property vacant for part of the year

Particulars			**Amount**
Computation of GAV			
Step 1	Compute ALV		
	ALV = Higher of MV and FR, but restricted to SR		
Step 2	Compute Actual rent received/receivable		
	Actual rent received/receivable for let out period less unrealized rent as per Rule 4		
Step 3	Compare ALV and Actual rent received/receivable		
Step 4	If Actual rent is lower than ALV owing to vacancy, then Actual rent is the GAV.		
	If Actual rent is lower than ALV due to other reasons, then ALV is the GAV.		
	However, in spite of vacancy, if the actual rent is higher than the ALV, then Actual rent is the GAV.		
Gross Annual Value (GAV)			A
Less:	Municipal taxes (paid by the owner during the previous year)		B
Net Annual Value (NAV) = (A-B)			C
Less:	**Deductions u/s 24**		
	(a) 30% of NAV	D	
	(b) Interest on borrowed capital		
	(actual without any ceiling limit)	E	
Income from house property (C-D-E)			F

5.12 Income Tax

Illustration 5

Ganesh has a property whose municipal valuation is Rs.2,50,000 p.a. The fair rent is Rs.2,00,000 p.a. and the standard rent fixed by the Rent Control Act is Rs.2,10,000 p.a. The property was let out for a rent of Rs.20,000 p.m. However, the tenant vacated the property on 31.1.10. Unrealised rent was Rs.20,000 and all conditions prescribed by Rule 4 are satisfied. He paid municipal taxes @8% of municipal valuation. Interest on borrowed capital was Rs.65,000 for the year. Compute the income from house property of Ganesh for A.Y.2010-11.

Solution

Computation of income from house property of Ganesh for A.Y.2010-11

Particulars		**Amount in Rs.**	
Computation of GAV			
Step 1	Compute ALV		
	ALV = Higher of MV of Rs.2,50,000 p.a. and FR of Rs.2,00,000 p.a., but restricted to SR of Rs.2,10,000 p.a.	2,10,000	
Step 2	Compute Actual rent received/receivable		
	Actual rent received/receivable for let out period less unrealized rent as per Rule 4 =2,00,000-20,000	1,80,000	
Step 3	Compare ALV and Actual rent received/receivable		
Step 4	In this case the actual rent of Rs.1,80,000 is lower than ALV of Rs.2,10,000 owing to vacancy, since, had the property not been vacant the actual rent would have been Rs.2,20,000 (Rs.1,80,000 + Rs.40,000). Therefore, actual rent is the GAV.	1,80,000	
Gross Annual Value (GAV)			**1,80,000**
Less:	Municipal taxes (paid by the owner during the previous year) = 8% of Rs.2,50,000 =		20,000
Net Annual Value (NAV) = (1,80,000-20,000)			**1,60,000**
Less:	**Deductions u/s 24**		
	(a) 30% of NAV = 30% of Rs.1,60,000	48,000	
	(b) Interest on borrowed capital (actual without any ceiling limit)	65,000	1,13,000
Income from house property =(1,60,000-48,000-65,000)			**47,000**

(iii) Self-occupied property or Unoccupied property

Particulars	Amount
Annual value under section 23(2)	Nil
Less: Deduction under section 24	
Interest on borrowed capital	E
Interest on loan taken for acquisition or construction of house on or after 1.4.99 and same was completed within 3 years from the end of the financial year in which capital was borrowed, interest paid or payable subject to a maximum of Rs.1,50,000 (including apportioned pre-construction interest).	
(ii) In case of loan for acquisition or construction taken prior to 1.4.99 or loan taken for repair, renovation or reconstruction at any point of time, interest paid or payable subject to a maximum of Rs.30,000.	
Income from house property	-E

Illustration 6

Poorna has one house property at Indra Nagar in Bangalore. She stays with her family in the house. The rent of similar property in the neighbourhood is Rs.25,000 p.m. The municipal valuation is Rs.23,000 p.m. Municipal taxes paid is Rs.8,000. The house was constructed in the year 2003 with a loan of Rs.20,00,000 taken from SBI Housing Finance Ltd. The construction was completed on 30.11.2006. The accumulated interest up to 31.3.2006 is Rs.1,50,000. During the previous year 2009-10, Poorna paid Rs.1,88,000 which included Rs.1,44,000 as interest. Compute Poorna's income from house property for A.Y. 2010-11.

Solution

Computation of income from house property of Smt. Poorna for A.Y.2010-11

Particulars	Amount
Annual Value of one house used for self-occupation under section 23(2)	Nil
Less: Deduction under section 24	
Interest on borrowed capital	
Interest on loan was taken for construction of house on or after 1.4.99 and same was completed within 3 years - interest paid or payable subject to a maximum of Rs.1,50,000 (including apportioned pre-construction interest) will be allowed as deduction.	1,50,000

In this case the total interest is Rs.1,44,000 + Rs.30,000 (Being 1/5th of Rs.1,50,000) = Rs.1,74,000. However, the interest deduction is restricted to Rs.1,50,000.	
Loss from house property	-1,50,000

(iv) House property let-out for part of the year and self-occupied for part of the year

Particulars			**Amount**
Computation of GAV			
Step 1	Compute ALV for the whole year		
	ALV = Higher of MV and FR, but restricted to SR		
Step 2	Compute Actual rent received/receivable		
	Actual rent received/receivable for the period let out less unrealized rent as per Rule 4		
Step 3	Compare ALV for the whole year with the actual rent received/receivable for the let out period		
Step 4	GAV is the higher of ALV computed for the whole year and Actual rent received/receivable computed for the let-out period.		
Gross Annual Value (GAV)			A
Less:	Municipal taxes (paid by the owner during the previous year)		B
Net Annual Value (NAV) = (A-B)			C
Less:	**Deductions u/s 24**		
	(a) 30% of NAV	D	
	(b) Interest on borrowed capital (actual without any ceiling limit)	E	
Income from house property (C-D-E)			F

Illustration 7

Smt.Rajalakshmi owns a house property at Adyar in Chennai. The municipal value of the property is Rs.5,00,000, fair rent is Rs.4,20,000 and standard rent is Rs.4,80,000. The property was let-out for Rs.50,000 p.m. up to December 2009. Thereafter, the tenant vacated the property and Smt. Rajalakshmi used the house for self-occupation. Rent for the months of November and December 2009 could not be realised in spite of the owner's efforts. All the

conditions prescribed under Rule 4 are satisfied. She paid municipal taxes @12% during the year. She had paid interest of Rs.25,000 during the year for amount borrowed for repairs for the house property. Compute her income from house property for the A.Y. 2010-11.

Solution

Computation of income from house property of Smt. Rajalakshmi for the A.Y.2010-11

Particulars		Amount in rupees	
Computation of GAV			
Step 1	Compute ALV for the whole year		
	ALV = Higher of MV of Rs.5,00,000 and FR of Rs.4,20,000, but restricted to SR of Rs.4,80,000	4,80,000	
Step 2	Compute Actual rent received/receivable		
	Actual rent received/receivable for the period let out less unrealized rent as per Rule 4 = (50000×9)-(50000×2)=4,50,000-1,00,000=	3,50,000	
Step 3	Compare ALV for the whole year with the actual rent received/receivable for the let out period i.e. 4,80,000 and 3,50,000		
Step 4	GAV is the higher of ALV computed for the whole year and Actual rent received/receivable computed for the let-out period.	4,80,000	
Gross Annual Value (GAV)			**4,80,000**
Less:	Municipal taxes (paid by the owner during the previous year) = 12% of Rs.5,00,000		60,000
Net Annual Value (NAV) = 4,80,000-60,000			**4,20,000**
Less:	**Deductions u/s 24**		
	(a) 30% of NAV = 30% of Rs.4,20,000	1,26,000	
	(b) Interest on borrowed capital	25,000	1,51,000
Income from house property (4,20,000-1,26,000-25,000)			**2,69,000**

(v) Deemed to be let out property

Particulars		Amount
Gross Annual Value (GAV)		A
	ALV is the GAV of house property	
	ALV = Higher of MV and FR, but restricted to SR	
Less:	Municipal taxes (paid by the owner during the previous year)	B
Net Annual Value (NAV) = (A-B)		C

5.16 Income Tax

Less:	**Deductions under section 24**		
	(a) 30% of NAV	D	
	(b) Interest on borrowed capital (actual without any ceiling limit)	E	
Income from house property (C-D-E)			F

Illustration 8

Ganesh has two houses, both of which are self-occupied. The particulars of the houses for the P.Y.2009-10 are as under:

Particulars	House I	House II
Municipal valuation p.a.	1,00,000	1,50,000
Fair rent p.a.	75,000	1,75,000
Standard rent p.a.	90,000	1,60,000
Date of completion	31.3.1999	31.3.2001
Municipal taxes paid during the year	12%	8%
Interest on money borrowed for repair of property during the current year	-	55,000

Compute Ganesh's income from house property for A.Y.2010-11 and suggest which house should be opted by Ganesh to be assessed as self-occupied so that his tax liability is minimum.

Solution

Computation of income from house property of Ganesh for the A.Y. 2010-11

Let us first calculate the income from each house property assuming that they are deemed to be let out.

Particulars	Amount in Rs.	
	House I	House II
Gross Annual Value (GAV)		
ALV is the GAV of house property		
ALV = Higher of MV and FR, but restricted to SR	90,000	1,60,000
Less: Municipal taxes (paid by the owner during the previous year)	12,000	12,000
Net Annual Value (NAV)	**78,000**	**1,48,000**
Less: Deductions under section 24		
(a) 30% of NAV	23,400	44,400
(b) Interest on borrowed capital	-	55,000
Income from house property	**54,600**	**48,600**

OPTION 1 (House I – self-occupied and House II – deemed to be let out)

If House I is opted to be self-occupied, the income from house property shall be –

Particulars	Amount in Rs.
House I (Self-occupied)	Nil
House II (Deemed to be let-out)	48,600
Income from house property	**48,600**

OPTION 2 (House I – deemed to be let out and House II – self-occupied)

If House II is opted to be self-occupied, the income from house property shall be –

Particulars	Amount in Rs.
House I (Deemed to be let-out)	54,600
House II (Self-occupied)	-30,000
(interest deduction restricted to Rs.30,000)	
Income from house property	**24,600**

Since Option 2 is more beneficial, Ganesh should opt to treat House II as self-occupied and House I as deemed to be let out. His income from house property would be Rs.24,600 for the A.Y. 2010-11.

(vi) House property, a portion let out and a portion self-occupied

Illustration 9

Prem owns a house in Madras. During the previous year 2009-10, 2/3rd portion of the house was self-occupied and 1/3rd portion was let out for residential purposes at a rent of Rs.8,000 p.m. Municipal value of the property is Rs.3,00,000 p.a., fair rent is Rs.2,70,000 p.a. and standard rent is Rs.3,30,000. He paid municipal taxes @10% of municipal value during the year. A loan of Rs.25,00,000 was taken by him during the year 2007 for acquiring the property. Interest on loan paid during the previous year 2009-10 was Rs.1,20,000. Compute Prem's income from house property for the A.Y. 2010-11.

Solution

There are two units of the house. Unit I with 2/3rd area is used by Prem for self-occupation throughout the year and no benefit is derived from that unit, hence it will be treated as self-occupied and its annual value will be nil. Unit 2 with 1/3rd area is let-out through out the previous year and its annual value has to be determined as per section 23(1).

5.18 Income Tax

Computation of Income from house property of Mr. Prem for A.Y. 2010-11

Particulars		Amount in rupees
Unit I (2/3rd area – self-occupied)		
Annual Value		Nil
Less: Deduction u/s 24(b)		
2/3rd of Rs.1,20,000		80,000
Income from Unit I (self-occupied)		**-80,000**
Unit II (1/3rd area – let out)		
Computation of GAV		
Step I – Compute ALV		
ALV = Higher of MV and FR, restricted to SR. However, in this case, SR of Rs.1,10,000 (1/3rd of Rs.3,30,000) is more than the higher of MV of Rs.1,00,000 (1/3rd of Rs.3,00,000) and FR of Rs.90,000 (1/3rd of Rs.2,70,000). Hence the higher of MV and FR is the ALV. In this case, it is the MV.	1,00,000	
Step 2 – Compute actual rent received/ receivable		
8,000×12 = 96,000	96,000	
Step 3 – GAV is the higher of ALV and actual rent received/receivable i.e. higher of Rs.1,00,000 and Rs.96,000	1,00,000	
Gross Annual Value(GAV)		**1,00,000**
Less: Municipal taxes paid by the owner during the previous year relating to let-out portion		
1/3rd of (10% of Rs.3,00,000) = 30000/3 = 10,000		10,000
Net Annual Value(NAV) = (1,00,000-10,000)		**90,000**
Less: Deductions under section 24		
(a) 30% of NAV = 30% of Rs.90,000	27,000	
(b) Interest paid on borrowed capital (relating to let out portion)		
1/3 rd of Rs.1,20,000	40,000	67,000
Income from Unit II (let-out)		**23,000**
Loss under the head "Income from house property" = -80,000 + 23,000		**-57000**

5.8 INADMISSIBLE DEDUCTIONS [SECTION 25]

Interest chargeable under this Act which is payable outside India shall not be deducted if –

(a) tax has not been paid or deducted from such interest and

(b) there is no person in India who may be treated as an agent under section 163.

5.9 TAXABILITY OF RECOVERY OF UNREALISED RENT & ARREARS OF RENT RECEIVED

(i) Unrealised rent is deducted from actual rent in determination of annual value under section 23, subject to fulfillment of conditions under Rule 4. Subsequently, when the amount is realised it gets taxed under section 25AA in the year of receipt.

(ii) If the assessee has increased the rent payable by the tenant and the same has been in dispute and later on the assessee receives the increase in rent as arrears, such arrears is assessable under section 25B.

	Unrealised rent [Section 25AA]	Arrears of rent [Section 25B]
(a)	Taxable in the hands of the assessee whether he is the owner of that property or not.	Taxable in the hands of the assessee whether he is the owner of that property or not.
(b)	Taxable as income of the previous year in which he recovers the unrealized rent.	Taxable as income of the year in which he receives the arrears of rent.
(c)	No deduction shall be allowed.	30% of the amount of arrears shall be allowed as deduction.
(d)	Unrealised rent means the rent which has been deducted from actual rent in any previous year for determining annual value.	Arrears of rent is in respect of rent not charged to income-tax for any previous year.

5.10 TREATMENT OF INCOME FROM CO-OWNED PROPERTY [SECTION 26]

(i) Where property is owned by two or more persons, whose shares are definite and ascertainable, then the income from such property cannot be taxed as income of an AOP.

(ii) The share income of each such co-owner should be determined in accordance with sections 22 to 25 and included in his individual assessment.

(iii) Where the house property owned by co-owners is self occupied by each of the co-owners, the annual value of the property of each co-owner will be Nil and each co-owner shall be entitled to a deduction of Rs.30,000/Rs.1,50,000, as the case may be, under section 24(b) on account of interest on borrowed capital.

(iv) Where the house property owned by co-owners is let out, the income from such property shall be computed as if the property is owned by one owner and thereafter the income so computed shall be apportioned amongst each co-owner as per their specific share.

5.20 Income Tax

5.11 TREATMENT OF INCOME FROM PROPERTY OWNED BY A PARTNERSHIP FIRM

(i) Where an immovable property or properties is included in the assets of a firm, the income from such property should be assessed in the hands of the firm only.

(ii) Hence, the property income cannot be assessed as income of the individual partner in respect of his share in the firm.

5.12 DEEMED OWNERSHIP [SECTION 27]

As per section 27, the following persons, though not legal owners of a property, are deemed to be the owners for the purposes of section 22 to 26.

(i) Transfer to a spouse [Section 27(i)] – In case of transfer of house property by an individual to his or her spouse otherwise than for adequate consideration, the transferor is deemed to be the owner of the transferred property.

Exception *– In case of transfer to spouse in connection with an agreement to live apart, the transferor will not be deemed to be the owner. The transferee will be the owner of the house property.*

(ii) Transfer to a minor child [Section 27(i)] – In case of transfer of house property by an individual to his or her minor child otherwise than for adequate consideration, the transferor would be deemed to be owner of the house property transferred.

Exception *– In case of transfer to a minor married daughter, the transferor is not deemed to be the owner.*

Note - Where cash is transferred to spouse/minor child and the transferee acquires property out of such cash, then the transferor shall not be treated as deemed owner of the house property. However, clubbing provisions will be attracted.

(iii) Holder of an impartible estate [Section 27(ii)] – The impartible estate is a property which is not legally divisible. The holder of an impartible estate shall be deemed to be the individual owner of all properties comprised in the estate.

After enactment of the Hindu Succession Act, 1956, all the properties comprised in an impartible estate by custom is to be assessed in the status of a HUF. However, section 27(ii) will continue to be applicable in relation to impartible estates by grant or covenant,.

(iv) Member of a co-operative society etc. [Section 27(iii)] – A member of a co-operative society, company or other association of persons to whom a building or part thereof is allotted or leased under a House Building Scheme of a society/company/association, shall be deemed to be owner of that building or part thereof allotted to him although the co-operative society/company/ association is the legal owner of that building.

(v) Person in possession of a property [Section 27(iiia)] – A person who is allowed to take or retain the possession of any building or part thereof in part performance of a contract of the nature referred to in section 53A of the Transfer of Property Act shall be the deemed owner of that house property. This would include cases where the –

(1) possession of property has been handed over to the buyer

(2) sale consideration has been paid or promised to be paid to the seller by the buyer

(3) sale deed has not been executed in favour of the buyer, although certain other documents like power of attorney/agreement to sell/will etc. have been executed.

In all the above cases, the buyer would be deemed to be the owner of the property although it is not registered in his name.

(vi) Person having right in a property for a period not less than 12 years [Section 27(iiib)] – A person who acquires any rights in or with respect to any building or part thereof, by virtue of any transaction as is referred to in section 269UA(f) i.e. transfer by way of lease for not less than 12 years, shall be deemed to be the owner of that building or part thereof.

Exception *– Any rights by way of lease from month to month or for a period not exceeding one year.*

5.13 CASES WHERE INCOME FROM HOUSE PROPERTY IS EXEMPT FROM TAX

Sl. No.	Section	Particulars
1	10(1)	Income from any farm house forming part of agricultural income.
2	10(19A)	Annual value of any one palace in the occupation of an ex-ruler.
3	10(20)	Income from house property of a local authority.
4	10(21)	Income from house property of an approved scientific research association.
5	10(23C)	Property income of universities, educational institutions, etc.
6	10(24)	Property income of any registered trade union.
7	11	Income from house property held for charitable or religious purpose.
8	13A	Property income of any political party.

9	22	Property used for own business or profession
10	23(2)	One self-occupied property of an individual/HUF

Self-examination questions

1. Discuss the following issues relating to Income from house property -
   (i) Income earned by residents from house properties situated in foreign countries.
   (ii) Properties which are used for agricultural purposes.
2. Discuss the provisions regarding taxability of the following –
   (i) Arrears of rent
   (ii) Unrealised rent
3. How is the income from house property of a house, which is self-occupied for part of the year and let out for part of the year, computed?
4. In certain cases, persons who are not legal owners of the house property are deemed to be owners for the purpose of charge of income-tax. Discuss the correctness or otherwise of the above statement.
5. Discuss the tax treatment of income from co-owned property.
6. In the following cases, state the head of income under which the receipt is to be assessed and comment.
   (1) X let out his property to Y. Y sublets it. How is subletting receipt to be assessed in the hands of Y.
   (2) X has built a house on a leasehold land. He has let-out the above property and claims income from house property under "Other sources" and deducted expenses on repairs, security charges, insurance and collection charges in all amounting to 40% of receipts.
7. An assessee, who was deriving income from house property, realised a sum of Rs.52,000 on account of display of advertisement hoardings of various concerns on the roof of the building. He claims that this amount should be considered under the head “Income from house property” and not “Income from other sources”. How do you deal with the following issue under the provisions of the Income-tax Act?
8. Arvind commenced construction of a residential house intended exclusively for his residence, on 1.11.2008. He raised a loan of Rs.5,00,000 at 16% p.a. for the purpose of construction on 1.11.2008. 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 1.10.2009. What is the interest allowable under section 24 for A.Y.2010-11, assuming that the construction was completed on 31.3.2010?

9. 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, 2009 and therefore, he let out the property w.e.f. 1.7.2009 on a monthly rent of Rs.8,000. The corporation tax payable in respect of the property was Rs.2,000 of which 50% was paid by him before 31.3.2010. Interest on money borrowed for the construction of the property amounted to Rs.12,000. Compute the income from house property for the A.Y.2010-11.

10. X Ltd. had let out the house property owned by it to the employees of its sister concern, Y Ltd. Under what head of income should the income from the house property of X Ltd., occupied by the employees of its sister concern Y Ltd., be assessed? Can X Ltd. claim that such income is not chargeable under the head "Income from house property", on the ground that the property has been occupied for the purpose of its business or profession?

Answer

8. Rs.1,50,000

9. Rs.54,500 (assuming the fair rent to be Rs. 8,000 per month)

10. These questions have been answered by the Madras High Court in *CIT vs. T.V. Sundaram Iyengar & Sons Ltd. (2005) 145 Taxman 380 / (2004) 271 ITR 0079*. The High Court observed that in order to claim exemption in respect of income from house property under section 22, the assessee must satisfy two conditions, namely –

(1) the property or portion thereof must be occupied by the assessee for the purposes of his business or profession; and

(2) the profits of such business should be chargeable to income-tax.

The issue under consideration is that in order to avail the exemption under section 22, is it necessary that the property must be –

(i) in direct occupation of the assessee-company, and

(ii) used as such for transaction of the assessee's business or profession.

The High Court observed that the term 'occupy' appearing in section 22, when judicially interpreted, means occupation, directly by the assessee himself or through an employee or agent, subservient and necessary for the performance of the duties

in connection with the business of the company. The assessee had let out the properties in question to the employees of the sister concern, who were separate and independent assessees by themselves, which made a vast difference from letting out of properties to the employees of the assessee itself. Therefore, the occupation of the properties in question by the employees of the sister concern could not be construed as an occupation by the employees of the assessee itself, in the absence of any specific provision in law to that effect.

Therefore, the income from the property let out to the employees of the sister concern Y Ltd. should be treated as income from house property of X Ltd. under section 22.

6

PROFITS AND GAINS OF BUSINESS OR PROFESSION

6.1 MEANING OF 'BUSINESS', 'PROFESSION' AND 'PROFITS'

(i) The tax payable by an assessee on his income under this head is in respect of the profits and gains of any business or profession, carried on by him or on his behalf during the previous year. The term "business" has been defined in section 2(13) to "include any trade, commerce or manufacture or any adventure or concern in the nature of trade, commerce or manufacture". But the term "profession" has not been defined in the Act. It means an occupation requiring some degree of learning. Thus, a painter, a sculptor, an author, an auditor, a lawyer, a doctor, an architect and, even an astrologer are persons who can be said to be carrying on a profession but not business. The term 'profession' includes vocation as well [Section 2(36)]. However, it is not material whether a person is carrying on a 'business' or 'profession' or 'vocation' since for purposes of assessment, profits from all these sources are treated and taxed alike.

(ii) Business necessarily means a continuous exercise of an activity; nevertheless, profit from a single venture in the nature of trade would also be assessable under this head if the venture had come to an end or after the entire cost had been recouped. For example, where a person had purchased a piece of land, got it surveyed, laid down a scheme of development, divided it into a number of building plots and sold some of the plots from time to time, though he would not be charged tax on a notional profit made on the individual sale of plots, he would be liable to pay tax on the surplus after all the plots have been sold and the venture has come to an end or after he has recovered the cost of all the plots and expenditure incidental thereto and has a surplus left.

(iii) Profits may be realised in money or in money's worth, i.e., in cash or in kind. Where profit is realised in any form other than cash, the cash equivalent of the receipt on the date of receipt must be taken as the value of the income received in kind. Capital receipts are not generally to be taken into account while computing profits under this head. Payment voluntarily made by persons who were under no obligation to pay anything at all would be income in the hands of the recipient, if they were received in the course of a business or by the exercise of a profession or vocation. Thus, any amount paid to a lawyer by a person who

was not a client, but who has been benefited by the lawyer's professional service to another would be assessable as the lawyer's income.

(iv) Application of the gains of trade is immaterial. Gains made even for the benefit of the community by a public body would be liable to tax. To attract the provisions of section 28, it is necessary that the business, profession or vocation should be carried on at least for some time during the accounting year but not necessarily throughout that year and not necessarily by the assessee-owner personally, but it should be under his direction and control.

(v) The charge is not on the gross receipts but on the profits and gains in their natural and proper sense. Profits are ascertained on ordinary principles of commercial trading and commercial accounting. According to section 145, income has to be computed in accordance with the method of accounting regularly and consistently employed by the assessee. The assessee may account for his receipts on the cash basis or mercantile basis.

(vi) The Act, however, contains certain provisions for determining how the income is to be assessed. These must be followed in every case of business or profession. The illegality of a business, profession or vocation does not exempt its profits from tax: the revenue is not concerned with the taint of illegality in the income or its source. Income is taxable even if the assessee is carrying on the business, profession or vocation without any profit motive. The liability to tax arises once income arises to the assessee; the motive or purpose of earning the income is immaterial. Thus, profit motive is not essential for describing the income from that activity as income from business or profession.

(vii) The profits of each distinct business must be computed separately but the tax chargeable under this section is not on the separate income of every distinct business but on the aggregate profits of all the business carried on by the assessee. Profits should be computed after deducting the losses and expenses incurred for earning the income in the regular course of the business, profession, or vocation unless the loss or expenses is expressly or by necessary implication, disallowed by the Act.

(viii) Income arising from business assets which are temporarily let out e.g., an oil mill, cinema theatre, hotel, ginning or textile factory, rice mill or jute press would be assessable as business income. But if the commercial asset is permanently let the income is taxable as income from house property or income from other sources, depending on the facts and circumstances of the case.

6.2 INCOME CHARGEABLE UNDER THIS HEAD [SECTION 28]

The various items of income chargeable to tax as income under the head 'profits and gains of business or profession' are as under:

(i) Income arising to any person by way of profits and gains from the business, profession or vocation carried on by him at any time during the previous year.

(ii) Any compensation or other payment due to or received by:

(a) Any person, by whatever name called, managing the whole or substantially the whole of (i) the affairs of an Indian company or (ii) the affairs in India of any other company at or in connection with the termination of his management or office or the modification of any of the terms and conditions relating thereto;

(b) any person, by whatever name called, holding an agency in India for any part of the activities relating to the business of any other person at or in connection with the termination of the agency or the modification of any of the terms and conditions relating thereto ;

(c) any person, for or in connection with the vesting in the Government or any corporation owned or controlled by the Government under any law for the time being in force, of the management of any property or business ;

By taxing compensation received on termination of agency or on the takeover of management (which is a capital receipt) as income from business, section 28(ii) provides exception to the general rule that capital receipts are not income taxable in the hands of the recipient.

(iii) Income derived by any trade, professional or similar associations from specific services rendered by them to their members. It may be noted that this forms an exception to the general principle governing the assessment of income of mutual associations such as chambers of commerce, stock brokers' associations etc. As a result a trade, professional or similar association performing specific services for its members is to be deemed as carrying on business in respect of these services and on that assumption the income arising therefrom is to be subjected to tax. For this purpose, it is not necessary that the income received by the association should be definitely or directly related to these services.

(iv) Profits on sale of a licence granted under the Imports (Control) Order, 1955 made under the Imports and Exports (Control) Act, 1947.

(v) Cash assistance (by whatever name called) received or receivable by any person against exports under any scheme of the Government of India.

(vi) Any Customs duty or Excise duty drawback repaid or repayable to any person against export under the Customs and Central Excise Duties Drawback Rules, 1971.

(vii) Any profit on the transfer of the Duty Entitlement Pass Book Scheme, being Duty Remission Scheme, under the export and import policy formulated and announced under section 5 of the Foreign Trade (Development and Regulation) Act, 1992.

(viii) Any profit on the transfer of Duty Free Replenishment Certificate, being Duty Remission Scheme, under the export and import policy formulated and announced under section 5

of the Foreign Trade (Development and Regulation) Act, 1992.

(ix) The value of any benefit or perquisite whether convertible into money or not, arising from business or the exercise of any profession.

(x) Any interest, salary, bonus, commission or remuneration, by whatever name called, due to or received by a partner of a firm from such firm will be deemed to be income from business. However, where any interest, salary, bonus, commission or remuneration by whatever name called, or any part thereof has not been allowed to be deducted under section 40(b), in the computation of the income of the firm the income to be taxed shall be adjusted to the extent of the amount disallowed. In other words, suppose a firm pays interest to a partner at 20% simple interest p.a. The allowable rate of interest is 12% p.a. Hence the excess 8% paid will be disallowed in the hands of the firm. Since the excess interest has suffered tax in the hands of the firm, the same will not be taxed in the hands of the partner.

(xi) Any sum received under a Keyman insurance policy including the sum allocated by way of bonus on such policy will be taxable as income from business. "Keyman insurance policy" means a life insurance policy taken by a person on the life of another person who is or was the employee of the first mentioned person or is or was connected in any manner whatsoever with the business of the first mentioned person.

(xii) Any sum received or receivable, in cash or kind, on account of any capital asset (in respect of which deduction has been allowed under section 35AD) being demolished, destroyed, discarded or transferred.

(xiii) any sum whether received or receivable, in cash or kind, under an agreement

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

(b) not to share 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.

However, the above sub-clause (a) shall not apply to -

(i) any sum, whether received or receivable, in cash or kind, on account of transfer of the right to manufacture, produce or process any article or thing or right to carry on any business, which is chargeable under the head "Capital gains";

(ii) any sum received as compensation, from the multilateral fund of the Montreal Protocol on Substances that Deplete the Ozone layer under the United Nations Environment Programme, in accordance with the terms of agreement entered into with the Government of India.

The Explanation for the purposes of this clause provides that

(i) "agreement" includes any arrangement or understanding or action in concert,-

(A) whether or not such arrangement, understanding or action is formal or in writing; or

(B) whether or not such arrangement, understanding or action is intended to be enforceable by legal proceedings;

(ii) "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.

6.3 SPECULATION BUSINESS

Explanation 2 to section 28 specifically provides that where an assessee carries on speculative business, that business of the assessee must be deemed as distinct and separate from any other business. This becomes necessary because section 73 provides that losses in speculation business unlike other business, cannot be set-off against the profits of any business other than a speculation business. Likewise, a loss in speculation business carried forward to a subsequent year can be set-off only against the profit and gains of any speculative business in the subsequent year. Profits and losses resulting from speculative transaction must, therefore, be treated as separate and distinct from other profits and gains of business and profession.

According to section 43(5), the expression "speculative transaction" means a transaction in which a contract for the purchase or sales of any commodity including stocks and shares, is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrips. Further, in view of Explanation to section 73, the transaction of purchase and sale of shares by non-banking and non-investment companies must also be deemed to be speculative transactions for tax purposes. However, the following forms of transactions shall not be deemed to be speculative transaction:

(i) a contract in respect of raw materials or merchandise entered into by a person in the course of his manufacturing or merchandising business to guard against loss through future price fluctuations in respect of his contracts for the actual delivery of goods manufactured by him or merchandise sold by him ; or

(ii) a contract in respect of stocks and shares entered into by a dealer or investor therein to guard against loss in his holdings of stocks and shares through price fluctuation; or

(iii) a contract entered into by a member of a forward market or stock exchange in the course of any transaction in the nature of jobbing or arbitrage to guard against any loss which may arise in the ordinary course of his business as a member; or

(iv) an eligible transaction carried out in respect of trading in derivatives in a recognized stock exchange.

(a) "eligible transaction" means any transaction,–

(A) carried out electronically on screen-based systems through a stock broker or sub-broker or such other intermediary registered under section 12 of the Securities and Exchange Board of India Act, 1992 in accordance with the provisions of the Securities Contracts (Regulation) Act, 1956 or the Securities and Exchange Board of India Act, 1992 or the Depositories Act, 1996 and the rules, regulations or bye-laws made or directions issued under those Acts or by banks or mutual funds on a recognised stock exchange; and

(B) which is supported by a time stamped contract note issued by such stock broker or sub-broker or such other intermediary to every client indicating in the contract note the unique client identity number allotted under any Act referred to in sub-clause (A) and permanent account number allotted under this Act;

(b) "recognised stock exchange" means a recognised stock exchange as referred to in clause (f) of section 2 of the Securities Contracts (Regulation) Act, 1956 and which fulfils such conditions as may be prescribed and notified by the Central Government for this purpose.'

Thus, in all the cases where actual delivery or transfer of the commodity or scrips takes place, the transaction would not amount to speculative transaction, however highly speculative it may be in its nature. The actual delivery may be symbolic and includes delivery effected by the mere transfer of delivery orders according to trade practice.

The instances stated above constitute the exceptions specifically provided by the Act, whereby certain transactions (e.g., hedging contracts) entered into by manufacturers and merchants in the course of their business to guard against the loss through price fluctuations are excluded from the definition of speculative transactions. This provision should be liberally construed to cover not only hedging forward contracts for purchase of goods but also such contracts for sale.

The Supreme Court held in *CIT v. Shantilal (P) Ltd. [1983] 144 ITR 57 (SC)* that an award of damages for breach of contract is not the same thing as a party to the contract accepting satisfaction of the contract otherwise than in accordance with the original terms thereof. In this view of the matter, the court held that in a case where a company contracted to sell a certain commodity to a party but was unable to effect delivery due to a sharp rise in the price of the commodity and the dispute which arose out of such breach of contract was settled by payment of damages as decided by an arbitrator, the transaction could not be described as a 'speculative transaction' within the meaning of section 43(5). This principle has been followed by various High Courts also.

6.4 COMPUTATION OF INCOME FROM BUSINESS [SECTION 29]

(i) According to section 29, the profits and gains of any business or profession are to be computed in accordance with the provisions contained in sections 30 to 43D. It must, however, be remembered that in addition to the specific allowances and deductions stated in sections 30 to 36, the Act further permits allowance of items of expenses under the residuary section 37(1), which extends the allowance to items of business expenditure not covered by sections 30 to 36, where these are allowable according to accepted commercial practices.

(ii) An item of loss or expenditure not falling within any of the express deductions may be allowed if it is deductible on the basis of common principles of commercial expediency. Thus, in determining whether a particular item (other than those covered by sections 30 to 36) is deductible from profits, it is necessary first to enquire whether the deduction is expressly or by necessary implication prohibited by the Act and then, if it is not so prohibited, to consider whether it is of such nature that it should be charged against income in the computation of the "profits and gains of business or profession". Accordingly, a loss due to embezzlement or theft of cash by an employee during the course of business is allowable as a deduction in computing the business profit, even though they are not covered by any specific provision of the Act. Losses of non-capital nature which are incidental to the trade and arise unexpectedly in the regular course of the business would be allowed as losses incidental to the trade though there is no specified provision in the Act for allowing such deductions. Examples of such losses are embezzlement, theft, robbery or destruction of assets, overdrawing by employees, loss of stock in trade by damage or by fire or by ravages of white ants or by enemy action during war or by negligence or fraud of employees, etc. However, if a businessman, having business connection with a non-resident, is unable to recover from the non-resident the amount of tax, he cannot claim it as a bad debt or business loss incidental to the trade on principles of commercial accounting as was held in *CIT v. Abdullabhai Abdul Kadar [1961] 41 ITR 546 (SC).*

(iii) Where a trader stands surety for the debt of another and such guarantee is not in the course of or for the purposes of trade, any payment made as a result of such guarantee cannot be deducted as a business loss except in a case where the contract of guarantee is entered into in the course of business pursuant to a trade or custom of which mutual accommodation is the essence e.g., trader standing surety for one another. Loss of cash in a bank on account of robbery by dacoits or loss through burglary of cash which the assessee is under legal obligation or business necessity required to keep in till it would be allowable as loss incidental to the trade. Losses arising from payments made as advances to employees and money lent by the managed company to the managing agents which had become irrecoverable would be incidental to the business provided that the amounts paid in advance or as loan were so made with reasonable business prudence and hence would be deductible.

(iv) Loss caused by embezzlement is allowable as a deduction not necessarily in the year in which the embezzlement takes place, but when there is no reasonable chance of obtaining

restitution and the amount is found to be irrecoverable. Normally when a businessman writes off the amount, it is a prima facie evidence of the fact that the amount has become irrecoverable. If embezzled or stolen moneys which are allowed as deduction in any year are subsequently recovered, they should be brought to tax as a revenue receipt from the business in the year of recovery.

(v) In respect of wasting assets or exhaustion of capital, no deduction is allowable from the income derived from such capital or wasting asset. Accordingly, where an annuity is purchased, the entire amount of annuity received is taxable regardless of the capital paid away and exhausted for the purchase of annuity. Likewise, in the case of a lease, the capital cost of the lease is not allowed to be deducted over the life of the lease.

6.5 ADMISSIBLE DEDUCTIONS

(i) Rent, rates, repairs and insurance for buildings [Section 30]

Section 30 allows deduction in respect of the rent, rates, taxes, repairs and insurance of buildings used by the assessee for the purpose of his business or profession. However, where the premises are used partly for business and partly for other purposes, only a proportionate part of the expenses attributable to that part of the premises used for purposes of business will be allowed as a deduction. Where the assessee has sublet a part of the premises, the allowance under the section would be confined to the difference between the rent paid by the assessee and the rent recovered from the sub-tenant. The rent payable would be an allowable deduction under this section even though the income from the property in respect of which it is paid may be exempt from taxation in the hands of the owner. Where the assessee himself is owner of the premises and occupies them for his business purposes, no notional rent would be allowed under this section. But where a firm runs its business in the premises owned by one of its partners, the rent payable to the partner will be an allowable deduction to the extent it is reasonable and is not excessive.

Apart from rent, this section allows deductions in respect of expenses incurred on account of repairs to building in case where (i) the assessee is the owner of the building or (ii) the assessee is a tenant who has undertaken to bear the cost of repairs to the premises. Even if the assessee occupies the premises otherwise than as a tenant or owner, i.e., as a lessee, licensee or mortgagee with possession, he is entitled to a deduction under the section in respect of current repairs to the premises.

In addition, deductions are allowed in respect of expenses by way of land revenue, local rates, municipal taxes and insurance in respect of the premises used for the purposes of the business or profession. Cesses, rates and taxes levied by a foreign Government are also allowed. Where the premises in respect of which these expenses are incurred are not utilized wholly for the purposes of the business, then, the deduction allowable should be of an amount proportionate to the use of the premises for the purposes of the business.

(ii) Repairs and insurance of machinery, plant and furniture [Section 31]

Section 31 allows deduction in respect of the expenses on current repairs and insurance of machinery, plant and furniture in computing the income from business or profession. In order to claim this deduction the assets must have been used for purposes of the assessee's own business the profits of which are being taxed. The word 'used' has to be read in a wide sense so as to include a passive as well as an active user. Thus, insurance and repair charges of assets which have been discarded (though owned by the assessee) or have not been used for the business during the previous year would not be allowed as a deduction. Even if an asset is used for a part of the previous year, the assessee is entitled to the deduction of the full amount of expenses on repair and insurance charges and not merely an amount proportionate to the period of use.

The term 'repairs' will include renewal or renovation of an asset but not its replacement or reconstruction. Also, the deduction allowable under this section is only of current repairs but not arrears of repairs for earlier years even though they may still rank for a deduction under section 37(1).

The deduction allowable in respect of premia paid for insuring the machinery, plant or furniture is subject to the following conditions: (i) The insurance must be against the risk of damage or destruction of the machinery, plant or furniture. (ii) The assets must be used by the assessee for the purposes of his business or profession during the accounting year. (iii) The premium should have been actually paid (or payable under the mercantile system of accounting). The premium may even take the form of contribution to a trade association which undertakes to indemnify and insure its members against loss; such premium or contribution would be deductible as an allowance under this section even if a part of it is returnable to the insured in certain circumstances. It does not matter if the payment of the claim will enure to the benefit of someone other than the owner.

Cost of repairs and current repairs of capital nature not to be allowed

As per section 30(a), deduction for cost of repairs to the premises occupied by the assessee as a tenant and the amount paid on account of current repairs to the premises occupied by the assessee, otherwise than as a tenant, is allowed.

As per section 31, the amount paid on account of current repairs of machinery, plant or furniture is allowed as deduction in the computation of income under the head "profits and gains of business or profession"

A view has been taken in *Hanuman Motor Service v. CIT (1967) 66 ITR 88*, 91 (Mys.) that in considering a claim for deduction under section 10(2)(v) of the 1922 Act (corresponding to section 30(a)(ii) of the 1961 Act), the question whether the expenditure is a capital expenditure or revenue expenditure is irrelevant. Once an expenditure has been established to be cost of repairs or current repairs, the same is allowable whether it is of a

revenue or capital nature.

Under the Income-tax Act, 1962 the concept of capital and revenue is of fundamental importance. Income-tax Act is an Act to bring to charge only revenue and not capital. Wherever the legislature has felt that capital receipts have to be charged to income-tax they have specifically included such capital receipts in the definition of income e.g. Capital gains. In the same way, wherever the legislature desired that capital expenditure should be allowed as a deduction, specific provisions have been made for such allowance e.g. capital expenditure on scientific research. While computing income under the Income-tax Act, only revenue receipts are to be considered against which only revenue expenditure is allowable unless the Act specifically allows the deduction of capital expenditure. Hence it is clear that in respect of cost of repairs and current repairs, as per correct accounting principles, only expenditure of revenue nature can be allowed.

To clarify this, the Explanation to section 30 and section 31 provides that the amount paid on account of the cost of repairs and the amount paid on account of current repairs shall not include any expenditure in the nature of capital expenditure.

(iii) Depreciation [Section 32]

(1) Section 32 allows a deduction in respect of depreciation resulting from the diminution or exhaustion in the value of certain capital assets.

The Explanation to this section provides that deduction on account of depreciation shall be made compulsorily, whether or not the assessee has claimed the deduction in computing his total income.

(2) The allowance of depreciation which is regulated by Rule 5 of the IT Rules, is subject to the following conditions which are cumulative in their application.

(a) The assets in respect of which depreciation is claimed must belong to either of the following categories, namely:

(i) buildings, machinery, plant or furniture, being tangible assets;

(ii) know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, being intangible assets acquired on or after 1st April, 1998.

The depreciation in the value of any other capital assets cannot be claimed as a deduction from the business income. No depreciation is allowable on the cost of the land on which the building is erected because the term 'building' refers only to superstructure but not the land on which it has been erected. The term 'plant' as defined in section 43(3) includes books, vehicles, scientific apparatus and surgical equipments. The expression 'plant' includes part of a plant (e.g., the engine of a vehicle); machinery includes part of a machinery and building includes a part of the building. However, the word 'plant' does not include an animal, human

body or stock-in-trade. Thus plant includes all goods and chattels, fixed or movable, which a businessman keeps for employment in his business with some degree of durability. Similarly the term 'buildings' includes within its scope roads, bridges, culverts, wells and tubewells.

(b) The assets should be actually used by the assessee for purposes of his business during the previous year - The asset must be put to use at any time during the previous year. The amount of depreciation allowance is not proportionate to the period of use during the previous year.

Asset used for less than 180 days - However, it has been provided that where any asset is acquired by the assessee during the previous year and is put to use for the purposes of business or profession for a period of less than 180 days, depreciation shall be allowed at 50 per cent of the allowable depreciation according to the percentage prescribed in respect of the block of assets comprising such asset. It is significant to note that this restriction applies only to the year of acquisition and not for subsequent years.

If the assets are not used exclusively for the business of the assessee but for other purposes as well, the depreciation allowable would be a proportionate part of the depreciation allowance to which the assessee would be otherwise entitled. This is provided in section 38.

Depreciation would be allowable to the owner even in respect of assets which are actually worked or utilized by another person e.g., a lessee or licensee. The deduction on account of depreciation would be allowed under this section to the owner who has let on hire his building, machinery, plant or furniture provided that letting out of such assets is the business of the assessee. In other cases where the letting out of such assets does not constitute the business of the assessee, the deduction on account of depreciation would still be allowable under section 57(ii).

(c) The assessee must own the assets, wholly or partly - In the case of buildings, the assessee must own the superstructure and not necessarily the land on which the building is constructed. In such cases, the assessee should be a lessee of the land on which the building stands and the lease deed must provide that the building will belong to the lessor of the land upon the expiry of the period of lease. Thus, no depreciation will be allowed to an assessee in respect of an asset which he does not own but only uses or hires for purposes of his business.

However, in this connection, students may note that the Explanation 1 to section 32 provides that where the business or profession of the assessee is carried on in a building not owned by him but in respect of which the assessee holds a lease or other right of occupancy, and any capital expenditure is incurred by the assessee for the purposes of the business or profession or the construction of any structure or doing of any work by way of renovation, extension or improvement to the building, then depreciation will be allowed as if the said structure or work is a building owned by the assessee.

Depreciation is allowable not only in respect of assets "wholly" owned by the assessee but also in respect of assets "partly" owned by him and used for the purposes of his business or profession.

(3) In case of succession of firm/sole proprietary concern by a company or amalgamation or demerger of companies - In order to restrict the double allowance under the proviso to section 32, in the cases of succession or amalgamation or demerger, the aggregate deduction in respect of depreciation allowable in the hands of the predecessor and the successor or in the case of amalgamating company and the amalgamated company or in the case of the demerged company and the resulting company, as the case may be, shall not exceed the amount of depreciation calculated at the prescribed rates as if the succession/amalgamation, demerger had not taken place. It is also provided that such deduction shall be apportioned between the two entities in the ratio of the number of days for which the assets were used by them.

(4) Hire purchase - In the case of assets under the hire purchase system the allowance for depreciation would under Circular No. 9 of 1943 R. Dis. No. 27(4) I.T. 43 dated 23-3-1943, be granted as follows :

1. In every case of payment purporting to be for hire purchase, production of the agreement under which the payment is made would be insisted upon by the department.
2. Where the effect of an agreement is that the ownership of the asset is at once transferred on the lessee the transaction should be regarded as one of purchase by instalments and consequently no deduction in respect of the hire amount should be made. This principle will be applicable in a case where the lessor obtains a right to sue for arrears of instalments but has no right to recover the asset back from the lessee. Depreciation in such cases should be allowed to the lessee on the hire purchase price determined in accordance with the terms of hire purchase agreement.
3. Where the terms of an agreement provide that the asset shall eventually become the property of the hirer or confer on the hirer an option to purchase an asset, the transaction should be regarded as one of hire purchase. In such case, periodical payments made by the hirer should for all tax purposes be regarded as made up of (i) the consideration for hirer which will be allowed as a deduction in assessment, and (ii) payment on account of the purchase price, to be treated as capital outlay and depreciation being allowed to the lessee on the initial value namely, the amount for which the hired assets would have been sold for cash at the date of the agreement. The allowance to be made in respect of the hire should be the amount of the difference between the aggregate amount of the periodical payments under the agreement and the initial value as stated above. The amount of this allowance should be spread over the duration of the agreement evenly. If, however, agreement is terminated either by outright purchase of the asset or by its return to the seller, the deduction should cease as from the date of termination of agreement.

For the purpose of allowing depreciation an assessee claiming deduction in respect of the assets acquired on hire purchase would be required to furnish a certificate from the seller or any other suitable documentary evidence in respect of the initial value or the cash price of the asset. In cases where no such certificate or other evidence is furnished the initial value of the

assets should be arrived at by computing the present value of the amount payable under the agreement at an appropriate per centum. For the purpose of allowing depreciation the question whether in a particular case the assessee is the owner of the hired asset or not is to be decided on a consideration of all the facts and circumstances of each case and the terms of the hire purchase agreement. Where the hired asset is originally purchased by the assessee and is registered in his name, the mere fact that the payment of the price is spread over the specified period and is made in instalments to suit the needs of the purchaser does not disentitle the assessee from claiming depreciation in respect of the asset, since the assessee would be the real owner although the payment of purchase price is made subsequent to the date of acquisition of the asset itself.

(5) Computation of Depreciation Allowance - Depreciation allowance will be calculated on the following basis:

(i) In the case of assets of an undertaking engaged in generation or generation and distribution of power, such percentage on the actual cost to the assessee as prescribed by Rule 5(1A).

Rule 5(1A) - As per this rule, the depreciation on the abovementioned assets shall be calculated at the percentage of the actual cost at rates specified in Appendix IA of these rules. However, the aggregate depreciation allowed in respect of any asset for different assessment years shall not exceed the actual cost of the asset. It is further provided that such an undertaking as mentioned above has the option of being allowed depreciation on the written down value of such block of assets as are used for its business at rates specified in Appendix I to these rules.

However, such option must be exercised before the due date for furnishing return under section 139(1) for the assessment year relevant to the previous year in which it begins to generate power. It is further provided that any such option once exercised shall be final and shall apply to all subsequent assessment years.

(ii) In the case of any block of assets, at such percentage of the written down value of the block, as may be prescribed by Rule 5(1).

Block of Assets - 1. A "block of assets" is defined in clause (11) of section 2 of the Act as a group of assets falling within a class of assets comprising—

(a) tangible assets, being buildings, machinery, plant or furniture;

(b) intangible assets, being know-how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of similar nature,

in respect of which the same percentage of depreciation is prescribed.

Know-how - In this context, 'know-how' means any industrial information or technique likely to assist in the manufacture or processing of goods or in the working of a mine, oil-

well or other sources of mineral deposits (including searching for discovery or testing of deposits for the winning of access thereto).

(iii) **Additional depreciation on Plant & Machinery acquired by an Industrial Undertaking**:

Additional depreciation is allowed on any new machinery or plant (other than ships and aircraft) acquired and installed after 31.3.2005 by an assessee engaged in the business of manufacture or production of any article or thing at the rate of 20% of the actual cost of such machinery or plant.

Such additional depreciation will not be available in respect of:

(i) any machinery or plant which, before its installation by the assessee, was used within or outside India by any other person; or

(ii) any machinery or plant installed in office premises, residential accommodation, or in any guest house; or

(iii) office appliances or road transport vehicles; or

(iv) any machinery or plant, the whole or part of the actual cost of which is allowed as a deduction (whether by way of depreciation or otherwise) in computing the income chargeable under the head "Profits and Gains of Business or Profession" of any one previous year.

(iv) **Terminal depreciation**

In case of a power concern as covered under clause (i) above, if any asset is sold, discarded, demolished or otherwise destroyed in the previous year, the depreciation amount will be the amount by which the monies payable in respect of such building, machinery, plant or furniture, together with the amount of scrap value, if any, falls short of the written down value thereof. The depreciation will be available only if the deficiency is actually written off in the books of the assessee.

"Moneys payable" in respect of any building, machinery, plant or furniture includes—

(a) any insurance, salvage or compensation moneys payable in respect thereof;

(b) where the building, machinery, plant or furniture is sold, the price for which it is sold, so, however, that where the actual cost of a motor-car is, in accordance with the proviso to clause (1) of section 43, taken to be Rs.25,000, the moneys payable in respect of such motor-car shall be taken to be a sum which bears to the amount for which the motor-car is sold or, as the case may be, the amount of any insurance, salvage or compensation moneys payable in respect thereof (including the amount of scrap value, if any) the same proportion as the amount of Rs.25,000 bears to the actual cost of the motor-car to the assessee as it would have been computed before applying the said proviso;

"Sold" 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, of any asset by the amalgamating company to the amalgamated company where the amalgamated company is an Indian company or a transfer of any asset by a banking company to a banking institution in a scheme of amalgamation of such banking company with the banking institution, sanctioned and brought into force by the Central Government.

(6) Actual Cost [Section 43(1)] - The expression "actual cost" means the actual cost of the asset to the assessee as reduced by that portion of the cost thereof, if any, as has been met directly or indirectly by any other person or authority.

Actual cost in certain special situations [Explanations to section 43(1)]

(i) Where an asset is used for the purposes of business after it ceases to be used for scientific research related to that business, the actual cost to the assessee for depreciation purposes shall be the actual cost to the assessee as reduced by any deduction allowed under section 35(1)(iv) [Explanation 1].

(ii) Where an asset is acquired by way of gift or inheritance, its actual cost shall be the written down value to the previous owner [Explanation 2].

(iii) Where, before the date of its acquisition by the assessee, the asset was at any time used by any other person for the purposes of his business or profession, and the Assessing Officer is satisfied that the main purpose of the transfer of the asset directly or indirectly to the assessee was the reduction of liability of income-tax directly or indirectly to the assessee (by claiming depreciation with reference to an enhanced cost) the actual cost to the assessee shall be taken to be such an amount which the Assessing Officer may, with the previous approval of the Joint Commissioner, determine, having regard to all the circumstances of the case [Explanation 3].

(iv) Where any asset which had once belonged to the assessee and had been used by him for the purposes of his business or profession and thereafter ceased to be his property by reason of transfer or otherwise, is re-acquired by him, the actual cost to the assessee shall be —

  (i) the written down value at the time of original transfer; or

  (ii) the actual price for which the asset is re-acquired by him

  whichever is less [Explanation 4].

(v) Where before the date of acquisition by the assessee say, Mr.A, the assets were at any time used by any other person, say Mr.B, for the purposes of his business or profession and depreciation allowance has been claimed in respect of such assets in the case of Mr.B and such person acquires on lease, hire or otherwise, assets from Mr.A, then, the actual cost of the transferred assets, in the case of Mr.A, shall be the same as the written

down value of the said assets at the time of transfer thereof by Mr.B [Explanation 4A].

We can explain the above as follows—

A person (say "A") owns an asset and uses it for the purposes of his business or profession. A has claimed depreciation in respect of such asset. The said asset is transferred by A to another person (say "B"). A then acquires the same asset back from B on lease, hire or otherwise. B being the new owner will be entitled to depreciation. In the above situation, the cost of acquisition of the transferred assets in the hands of B shall be the same as the written down value of the said assets at the time of transfer.

Explanation 4A overrides Explanation 3 - Explanation 3 to section 43(1) deals with a situation where a transfer of any asset is made with the main purpose of reduction of tax liability (by claiming depreciation on enhanced cost), and the Assessing Officer, having satisfied himself about such purpose of transfer, may determine the actual cost having regard to all the circumstances of the case.

In the Explanation 4A, a *non-obstante* clause has been included to the effect that Explanation 4A will have an overriding effect over Explanation 3. The result of this is that there is no necessity of finding out whether the main purpose of the transaction is reduction of tax liability. Explanation 4(A) is activated in every situation described above without inquiring about the main purpose.

(vi) Where a building which was previously the property of the assessee is brought into use for the purposes of the business or profession, its actual cost to the assessee shall be the actual cost of the building to the assessee, as reduced by an amount equal to the depreciation calculated at the rates in force on that date that would have been allowable had the building been used for the purposes of the business or profession since the date of its acquisition by the assessee [Explanation 5].

(vii) When any capital asset is transferred by a holding company to its subsidiary company or by a subsidiary company to its holding company then, if the conditions specified in section 47(iv) or (v) are satisfied, the transaction not being regarded as a transfer of a capital asset, the actual cost of the transferred capital asset to the transferee company shall be taken to be the same as it would have been if the transferor company had continued to hold the capital asset for the purposes of its own business [Explanation 6].

(viii) In a scheme of amalgamation, if any capital asset is transferred by the amalgamating company to the amalgamated company, the actual cost of the transferred capital assets to the amalgamated company will be taken at the same amount as it would have been taken in the case of the amalgamating company had it continued to hold it for the purposes of its own business [Explanation 7].

In the case of a demerger, where any capital asset is transferred by the demerged company to the resulting company, the actual cost of the transferred asset to the

resulting company shall be taken to be the same as it would have been if the demerged company had continued to hold the asset. However, the actual cost shall not exceed the WDV of the asset in the hands of the demerged company [Explanation 7A].

(ix) Certain taxpayers have, with a view to obtain more tax benefits and reduce the tax outflow, resorted to the method of capitalising interest paid or payable in connection with acquisition of an asset relatable to the period after such asset is first put to use. Certain judicial rulings also favoured this approach. This capitalisation implies inclusion of such interest in the 'Actual Cost' of the asset for the purposes of claiming depreciation, investment allowance etc. under the Income-tax Act. This was never the legislative intent nor was it in accordance with recognised accounting practices. Therefore, with a view to counter-acting tax avoidance through this method and placing the matter beyond doubt, Explanation 8 to section 43(1) provides that any amount paid or payable as interest in connection with the acquisition of an asset and relatable to period after asset is first put to use shall not be included and shall be deemed to have never been included in the actual cost of the asset [Explanation 8].

(x) Where an asset is or has been acquired by an assessee, the actual cost of asset shall be reduced by the amount of duty of excise or the additional duty leviable under section 3 of the Customs Tariff Act, 1975 in respect of which a claim of credit has been made and allowed under the Central Excise Rules, 1944 [Explanation 9].

(xi) Where a portion of the cost of an asset acquired by the assessee has been met directly or indirectly by the Central Government or a State Government or any authority established under any law or by any other person, in the form of a subsidy or grant or reimbursement (by whatever name called), then, so much of the cost as is relatable to such subsidy or grant or reimbursement shall not be included in the actual cost of the asset to the assessee.

However, where such subsidy or grant or reimbursement is of such nature that it cannot be directly relatable to the asset acquired, so much of the amount which bears to the total subsidy or reimbursement or grant the same proportion as such asset bears to all the assets in respect of or with reference to which the subsidy or grant or reimbursement is so received, shall not be included in the actual cost of the asset to the assessee [Explanation 10].

(xii) Where an asset is acquired outside India by an assessee, being a non-resident and such asset is brought by him to India and used for the purposes of his business or profession, the actual cost of asset to the assessee shall be the actual cost the asset to the assessee, as reduced by an amount equal to the amount of depreciation calculated at the rate in force that would have been allowable had the asset been used in India for the said purposes since the date of its acquisition by the assessee [Explanation 11].

(xiii) Where any capital asset is acquired under a scheme for corporatisation of a recognised stock exchange in India approved by the SEBI, the actual cost shall be deemed to be the amount which would have been regarded as actual cost had there been no such corporatisation.

(xiv) Explanation 13 has been inserted in section 43(1) to provide that the actual cost of any capital asset, on which deduction has been allowed or is allowable to the assessee under section 35AD, shall be nil. This would be applicable in the case of transfer of asset by the assessee where -

(1) the assessee himself has claimed deduction under section 35AD; or

(2) the previous owner has claimed deduction under section 35AD. This would be applicable where the capital asset is acquired by the assessee by way of -

(a) gift, will or an irrevocable trust;

(b) any distribution on liquidation of the company;

(c) any distribution of capital assets on total or partial partition of a HUF;

(d) any transfer of a capital asset by a holding company to its 100% subsidiary company, being an Indian company;

(e) any transfer of a capital asset by a subsidiary company to its 100% holding company, being an Indian company;

(f) any transfer of a capital asset by the amalgamating company to an amalgamated company in a scheme of amalgamation, if the amalgamated company is an Indian company;

(g) any transfer of a capital asset by the demerged company to the resulting company in a scheme of demerger, if the resulting company is an Indian company;

(h) any transfer of a capital asset or intangible asset by a firm to a company as a result of succession of the firm by a company in the business carried on by the firm, or any transfer of a capital asset to a company in the course of demutualization or corporatisation of a recognized stock exchange in India as a result of which an association of persons or body of individuals is succeeded by such company (fulfilling the conditions specified);

(i) any transfer of a capital asset or intangible asset by a sole proprietory concern to a company, where the sole proprietory concern is succeeded by a company (fulfilling the conditions specified).which would have been regarded as actual cost had there been no such corporatisation.

Definition of plant [Section 43(3)] – "Plant" includes ships, vehicles, books, scientific apparatus and surgical equipment used for the purposes of business or profession but does not include tea bushes or livestock or buildings or furniture and fittings.

(7) Written down value [Section 43(6)] - (i) In the case of assets acquired by the assessee during the previous year, the written down value means the actual cost to the assessee.

(ii) In the case of assets acquired before the previous year, the written down value would be the actual cost to the assessee less the aggregate of all deductions actually allowed in respect of depreciation. For this purpose, any depreciation carried forward is deemed to be depreciation actually allowed [Section 43(6)(c)(i) read with Explanation (3)].

The written down value of any asset shall be worked out as under in accordance with section 43(6)(c) -

(1) The aggregate of the written down value of the block of assets at the beginning of the previous year.

(2) The sum arrived at as above shall be increased by the actual cost of any asset falling within that block which is acquired by the assessee during the previous year.

(3) The sum so arrived at shall be reduced by the sale proceeds and other amounts receivable by the assessee with regard to any asset falling within that block which is sold, discarded, demolished or destroyed during that previous year.

(iii) When in the case of a succession to business or profession, an assessment is made on the successor under section 170(2), the written down value of an asset or block of assets shall be the amount which would have been taken as the written down value if the assessment had been made directly on the person succeeded to [Explanation 1 to section 43(6)].

(iv) Where in any previous year any block of assets is transferred by a holding company to a subsidiary company or vice versa and the conditions of clause 47(iv) or (v) are satisfied or by an amalgamating company to an amalgamated company the latter being an Indian company then the actual cost of the block of assets in the case of transferee-company or amalgamated company as the case may be, shall be the written down value of the block of assets as in the case of the transferor company or amalgamating company, as the case may be, for the immediately preceding year as reduced by depreciation actually allowed in relation to the said previous year [Explanation 2 to section 43(6)].

(v) Where in any previous year any asset forming part of a block of assets is transferred by demerged company to the resulting company, the written down value of the block of assets of the demerged company for the immediately preceding year shall be reduced by the written down value of the assets transferred to the resulting company [Explanation 2A to section 43(6)].

(vi) Where any asset forming part of a block of assets is transferred by a demerged company to the resulting company, the written down value of the block of assets in the case of resulting company shall be the written down value of the transferred assets of the demerged company immediately before the demerger [Explanation 2B to section 43(6)].

(vii) Where any asset forming part of a block of assets is transferred in any previous year by a recognised stock exchange in India to a company under a scheme for corporatisation approved by SEBI, the written down value of the block shall be the written down value of the transferred assets immediately before the transfer[Explanation 5 to section 43(6)].

(viii) Depreciation provided in the books of account deemed to be depreciation actually allowed [Explanation 6 to section 43(6)]

Section 32(1)(ii) provides that depreciation shall be allowed at the prescribed percentage on the written down value (WDV) of any block of assets. Section 43(6)(b) provides that written down value in the case of assets acquired before the previous year means the actual cost to the assessee less all depreciation actually allowed to him under the Income-tax Act.

Persons who were exempt from tax were not required to compute their income under the head "Profits and gains of business or profession". However, when the exemption is withdrawn subsequently, such persons became liable to income-tax and hence, were required to compute their income for income-tax purposes. In this regard, a question arises as to the basis on which depreciation is to be allowed under the Income-tax Act in respect of assets acquired during the years when the person was exempt from tax.

Explanation 6 has been inserted in section 43(6) to provide that,-

(a) the actual cost of an asset has to be adjusted by the amount attributable to the revaluation of such asset, if any, in the books of account;

(b) the total amount of depreciation on such asset provided in the books of account of the assessee in respect of such previous year or years preceding the previous year relevant to the assessment year under consideration shall be deemed to be the depreciation actually allowed under the Income-tax Act for the purposes of section 43(6);

(c) the depreciation actually allowed as above has to be adjusted by the amount of depreciation attributable to such revaluation.

(ix) Explanation 7 provides that in cases of 'composite income', for the purpose of computing written down value of assets acquired before the previous year, the total amount of depreciation shall be computed as if the entire composite income of the assessee is chargeable under the head "Profits and Gains of business or profession". The depreciation so computed shall be deemed to have been "actually allowed" to the assessee.

For instance, Rule 8 prescribes the taxability of income from the manufacture of tea. Under the said rule, income derived from the sale of tea grown and manufactured by seller shall be computed as if it were income derived from business, and 40% of such income shall be deemed to be income liable to tax. If the turnover is, say, Rs.20 lakh, the depreciation Rs.1 lakh and other expenses Rs.4 lakh, then the income would be Rs.15 lakh. Business income would be

Rs.6 lakh (being 40% of Rs.15 lakh). As per earlier Court decisions, only the depreciation "actually allowed" i.e., Rs.40,000, being 40% of Rs.1 lakh, has to be deducted to arrive at the written down value. The ambiguity in this case has arisen on account of the interpretation of the meaning of the phrase "actually allowed" used in section 43(6)(b). However, the correct legislative intent is that the WDV is required to be computed by deducting the full depreciation attributable to composite income i.e. Rs.1 lakh in this case. Explanation 7 clarifies this legislative intent.

(x) The written down value of any block of assets, may be reduced to nil for any of the following reasons:

(a) The moneys receivable by the assessee in regard to the assets sold or otherwise transferred during the previous year together with the amount of scrap value may exceed the written down value at the beginning of the year as increased by the actual cost of any new asset acquired, or

(b) All the assets in the relevant block may be transferred during the year.

(8) Rates of depreciation

All assets have been divided into four main categories and rates of depreciation as prescribed by Rule 5(1) are given below :

PART A TANGIBLE ASSETS

I Buildings

Block 1.	Buildings (other than covered by sub-item 3 below) which are used mainly for residential purposes	5%
Block 2.	Buildings which are not used mainly for residential purposes and not covered by sub-items (1) above and (3) below	10%
Block 3.	Buildings acquired on or after the 1st day of September, 2002 for installing machinery and plant forming part of water supply project or water treatment system and which is put to use for the purpose of business of providing infrastructure facilities under clause (i) of sub-section (4) of section 80-IA	100%
Block 4.	Purely temporary erections such as wooden structures	100%

II Furniture and Fittings

Block 1.	Furniture and fittings including electrical fittings	10%

III Plant & Machinery

Block 1.	Motors buses, motor lorries, motor taxis used in a business of running them on hire	30%

Block 2	Aeroplanes, aeroengines	40%
Block 3.	Air, Water Pollution control equipments, Solid waste control equipment	100%
Block 4.	Energy Saving Devices	80%
Block 5.	Motor cars other than those used in a business of running them on hire, acquired or put to use on or after 1-4-1990.	15%
Block 6	Computers including computer software	60%
Block 7.	Annual Publications owned by assessees carrying on a profession	100%
Block 8.	Books owned by assessees carrying on business in running lending libraries	100%
Block 9.	Books, other than annual publications, owned by assesses carrying on a profession	60%
Block 10.	Plant & machinery (General rate)	15%
IV Ships		
Block 1.	Ocean-going ships	20%
Block 2.	Vessels ordinarily operating on inland waters not covered by sub-item 3 below	20%
Block 3.	Speed boats operating on inland water	20%
PART B	**INTANGIBLE ASSETS**	
	Know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature	25%

Students should refer to Income-tax Rules for the detailed classification of assets under Rule 5(1) and the rates applicable thereto.

Notification No. 37/2009 dated 21.4.2009

"New commercial vehicles acquired on or after 1.1.2009 but before 1.10.2009 and put to use before 1.10.2009 for the purposes of business or profession" would be classified under the head MACHINERY AND PLANT and would be eligible for depreciation at the rate of 50%.

(9) Increased rate of depreciation for certain assets - Rule 5(2) - Any new machinery or plant installed to manufacture or produce any article or thing by using any technology or other know-how developed in a laboratory owned or financed by the Government or a laboratory owned by a public sector company or a University or an institution recognized by the Secretary, Department of Scientific and Industrial Research, Government of India shall be treated as a part of the block of assets qualifying for depreciation@ 40%.

Conditions to be fulfilled

1. The right to use such technology to manufacture such article has been acquired from the owner of such laboratory or any person deriving title from such owner.

2. The return filed by the assessee for any previous year in which the said machinery is acquired, should be accompanied by a certificate from the Secretary, Department of Scientific and Industrial Research, Government of India to the effect that such article is manufactured by using such technology developed in such laboratory or such article has been invented in that laboratory.

3. The machinery or plant is not used for the purpose of business of manufacture or production of any article or thing specified in the Eleventh schedule.

The depreciation ordinarily allowable to an assessee in respect of any block of assets shall be calculated at the above specified rates on the WDV of such block of assets as are used for the purposes of the business or profession of the assessee at any time during the previous year.

(10) Carry forward and set off of depreciation [Section 32(2)]

Section 32(2) provides for carry forward of unabsorbed depreciation. Where, in any previous year the profits or gains chargeable are not sufficient to give full effect to the depreciation allowance, the unabsorbed depreciation shall be added to the depreciation allowance for the following previous year and shall be deemed to be part of that allowance. If no depreciation allowance is available for that previous year, the unabsorbed depreciation of the earlier previous year shall become the depreciation allowance of that year. The effect of this provision is that the unabsorbed depreciation shall be carried forward indefinitely till it is fully set off.

However, in the order of set-off of losses under different heads of income, effect shall first be given to business losses and then to unabsorbed depreciation.

The provisions in effect are as follows:

- Since the unabsorbed depreciation now falls part of the current year's depreciation, it can be set off against any other head of income.
- The unabsorbed depreciation can be carried forward for indefinite number of previous years.
- Set off will be allowed even if the same business to which it relates is no longer in existence in the year in which the set off takes place.

Current depreciation to be deducted first - The Supreme Court in *CIT v. Mother India Refrigeration (P.) Ltd*. [1985] 23 Taxman 8 has categorically held that current depreciation must be deducted first before deducting the unabsorbed carried forward business losses of the earlier years in giving set off while computing the total income of any particular year.

6.24 Income Tax

Illustration 1

A newly qualified Chartered Accountant Mr. Dhaval, commenced practice and has acquired the following assets in his office during F.Y. 2009-10 at the cost shown against each item. Calculate the amount of depreciation that can be claimed from his professional income for A.Y. 2010-11:

Sl. No.	Description	Date of acquisition	Date when put to use	Amount Rs.
1.	Computer	27 Sept., 09	1 Oct., 09	35,000
2.	Computer software	2 Oct., 09	4 Oct., 09	8,500
3.	Computer printer	2 Oct., 09	1 Oct., 09	12,500
4.	Books (of which books being annual publications are of Rs.12,000)	1 Apr., 09	1 Apr., 09	13,000
5.	Office furniture (Acquired from a practising C.A.)	1 Apr., 09	1 Apr., 09	3,00,000
6.	Laptop	26 Sep., 09	4 Oct., 09	43,000

Solution

Computation of depreciation allowable for A.Y.2010-11

	Asset	Rate	Depreciation
Block 1	Furniture	10%	30,000
Block 2	Plant (Computer, computer software, laptop & books)	60%	37,050
Block 3	Plant (Books)	100%	12,000
Block 4	Plant (Printer)	15%	1,875
	Total depreciation allowable		**80,925**

Notes -

1. Computation of depreciation

Block of Assets	**Rs.**
Block 1: Furniture – rate 10%	
Put to use for more than 180 days [Rs.3,00,000@10%]	**30,000**
Block 2: Plant – rate 60%	
(a) Computer (put to use for more than 180 days) [35,000 @ 60%]	21,000
(b) Laptop (put to use for less than 180 days) [43,000 @ 30%]	12,900

(c) Computer Software (put to use for less than 180 days) [8,500@ 30%]	2,550
(d) Books (other than annual publications) (Put to use for more than 180 days) [1,000 @ 60%]	600
	37,050
Block 3: Plant – Rate 100%	
Books (being annual publications) put to use for more than 180 days [12,000@100%]	**12,000**
Block 4: Plant – Rate 15%	
Computer printer (Put to use for more than180 days) [12,500 @15%]	1,875

2. Where an asset is acquired by the assessee during the previous year and is put to use for the purposes of business or profession for a period of less than 180 days, the deduction on account of depreciation would be restricted to 50% of the prescribed rate. In this case, since Mr.Dhaval commenced his practice in the P.Y.2009-10 and acquired the assets during the same year, the restriction of depreciation to 50% of the prescribed rate would apply to those assets which have been put to use for less than 180 days in that year, namely, laptop and computer software.

Illustration 2

Gamma Ltd. was incorporated on 1.1.2009 for manufacture of tyres and tubes for motor vehicles. The manufacturing unit was set up on 1.5.2009. The company commenced its manufacturing operations on 1.6.2009. The total cost of the plant and machinery installed in the unit is Rs.120 crore. The said plant and machinery included second hand plant and machinery bought for Rs.20 crore and new plant and machinery for scientific research relating to the business of the assessee acquired at a cost of Rs.15 crore.

Compute the amount of depreciation allowable under section 32 of the Income-tax Act, 1961 in respect of the assessment year 2010-11.

Solution

Computation of depreciation allowable for the A.Y. 2010-11 in the hands of Gamma Ltd.

Particulars	Rs. in crore	
Total cost of plant and machinery	120.00	
Less: Used for Scientific Research (Note 1)	15.00	
	105.00	
Normal Depreciation at 15% on Rs.105 crore		15.75
Additional Depreciation:		
Cost of plant and machinery	120.00	

6.26 Income Tax

Less:	Second hand plant and machinery (Note 2)	20.00		
	Plant and machinery used for scientific research, the whole of the actual cost of which is allowable as deduction under section 35(2)(ia) (Note 2)	15.00	35.00	
			85.00	
Additional Depreciation at 20%				17.00
Depreciation allowable for A.Y.2010-11				**32.75**

Notes:

1. As per section 35(2)(iv), no depreciation shall be allowed in respect of plant and machinery purchased for scientific research relating to assessee's business, since deduction is allowable under section 35 in respect of such capital expenditure.

2. As per section 32(1)(iia), additional depreciation is allowable in the case of any new machinery or plant acquired and installed after 31.3.2005 by an assessee engaged in the business of manufacture or production of any article or thing, at the rate of 20% of the actual cost of such machinery or plant.

However, additional depreciation shall not be allowed in respect of, inter alia, –

(i) any machinery or plant which, before its installation by the assessee, was used either within or outside India by any other person;

(ii) any machinery or plant, the whole of the actual cost of which is allowed as a deduction (whether by way of depreciation or otherwise) in computing the income chargeable under the head "Profit and gains of business or profession" of any one previous year.

In view of the above provisions, additional depreciation cannot be claimed in respect of -

(i) Second hand plant and machinery;

(ii) New plant and machinery purchased for scientific research relating to assessee's business in respect of which the whole of the capital expenditure can be claimed as deduction under section 35(1)(iv) read with section 35(2)(ia).

(11) Balancing Charge - Section 41(2) provides for the manner of calculation of the amount which shall be chargeable to income-tax as income of the business of the previous year in which the monies payable for the building, machinery, plant or furniture on which depreciation has been claimed under section 32(1)(i), i.e. in the case of power undertakings, is sold, discarded, demolished or destroyed. The balancing charge will be the amount by which the moneys payable in respect of such building, machinery, plant or furniture, together with the amount of scrap value, if any, exceeds the written down value. However, the amount of balancing charge should not exceed the difference between the actual cost and the WDV. The tax shall be levied in the year in which the moneys payable become due.

The *Explanation* below section 41(2) makes it clear that where the moneys payable in respect of the building, machinery, plant or furniture referred to in section 41(2) become due in a previous year in which the business, for the purpose of which the building, machinery, plant or furniture was being used, is no longer in existence, these provisions will apply as if the business is in existence in that previous year.

(iv) Tea Development Account/Coffee Development Account/Rubber Development Account [Section 33AB]

(1) Where an assessee carrying on the business of growing and manufacturing tea or coffee or rubber in India has, before the expiry of six months from the end of the previous year or before the due date of furnishing the return of income, whichever is earlier, (i) deposited with a National Bank any amount in a special account maintained by the assessee with that Bank in accordance with a scheme approved by Tea Board or Coffee Board or Rubber Board, or (ii) opened an account to be known as Deposit Account in accordance with the scheme framed by the Tea Board or Coffee Board or Rubber Board, as the case may be, with the previous approval of the Central Government, the assessee shall be allowed a deduction of :

(a) A sum equal to the aggregate of the deposits made or

(b) 40% of the profits of such business computed under the head 'Profits and Gains of Business of Profession' before making any deduction under this section,

whichever is less.

(2) The above deduction will be allowed before the setting off of brought-forward loss under section 72.

(3) Where the assessee is a firm or any association of persons or any body of individuals the deduction under this section shall not be allowed in the computation of the income of any partner or member of such firm, AOP or BOI.

(4) This deduction shall not be allowed unless the accounts of such business of the assessee for the previous year have been audited by a chartered accountant and the assessee furnishes along with his return of income the report of such audit in the prescribed form duly signed and verified by such accountant [Form No. 3AC].

(5) However, where the assessee is required by any other law to get his accounts audited it shall be sufficient compliance with the provision of this section if such assessee gets the accounts of such business audited under any such law and furnishes the report of the audit and a further report in the prescribed form under this section.

(6) Any amount standing to the credit of the assessee in the special account cannot be withdrawn except for the purposes specified in the scheme, or, as the case may be, in the deposit scheme.

The above amount can also be withdrawn in the following circumstances:

6.28 Income Tax

(a) Closure of business

(b) Death of an assessee

(c) Partition of HUF

(d) Dissolution of a firm

(e) Liquidation of a company.

(7) Where the sum standing to the credit of the assessee in the Special account or in the Deposit account is released by the National Bank or is withdrawn by the assessee from the Deposit account and is utilised for the purchase of:

(a) Any machinery or plant installed in any office premises or residential accommodation including a guest house.

(b) Any office appliances (other than computers)

(c) Any machinery or plant the whole of whose actual cost is allowed as deduction by way of depreciation or otherwise in computing the business income.

(d) Any new machinery or plant installed for production of any XI Schedule item,

the whole of such amount so utilised will be treated as taxable profits of that year and taxed accordingly.

(8) Where any amount is withdrawn by the assessee from the special account during any previous year on the closure of his business or dissolution of a firm, the whole of such withdrawal shall be deemed to be the profits and gains of business of that previous year and shall be chargeable to tax as the income of that previous year, as if the business had not closed or the firm had not been dissolved.

(9) Where any amount standing to the credit of the assessee in the special account is utilised by the assessee for the purpose of any expenditure in connection with such business in accordance with the scheme, such expenditure shall not be allowed in computing the business income.

(10) Where any amount in the special account which is released during any previous year by the National Bank for being utilised by the assessee for the purposes of such business in accordance with the scheme is not so utilised within that previous year, the unutilised amount shall be deemed to be profits and gains and chargeable to income-tax as the income of that previous year.

However, where such amount is released during the previous year at the closing of the account on the death of the assessee, partition of a HUF or liquidation of a company, the above restriction will not apply.

(11) Where an asset acquired in accordance with the scheme is sold or otherwise transferred

in any previous year by the assessee to any person at any time before the expiry of 8 years from the end of the previous year in which it was acquired, such portion of the cost equal to the deduction allowed under this section shall be deemed to be profits of the previous year in which the asset is sold or transferred and shall be chargeable to income-tax as the income of that previous year.

However, the above restriction will not apply in the following cases :

(i) Where the asset is sold or otherwise transferred to Government, local authority, statutory corporation or a Government company.

(ii) Where the sale or transfer is made in connection with the succession of a firm by a company in the business or profession carried on by the firm as result of which the firm sells or otherwise transfers any asset to the company and the scheme continues to apply to the company in the same manner as applicable to the firm. Further, all the properties of the firm relating to the business or profession immediately before the succession should become the liabilities of the company and all the shareholders of the company should have been partners of the firm immediately before the succession.

(12) The Central Government has the power to direct that the deduction allowable under this section shall not be allowed after a specified date.

(13) "National Bank" means the National Bank for Agricultural and Rural Development (NABARD).

(v) Site Restoration Fund [Section 33ABA] – (1) This section provides for a deduction in the computation of the taxable profits in the case of an assessee carrying on business of prospecting for, or extraction or production, of petroleum or natural gas or both in India and in relation to which the Central Government has entered into an agreement with such assessee for such business.

(2) It provides that where the assessee has during the previous year -

(i) deposited any sum with the State Bank of India in a special account maintained by the assessee with that bank in accordance with the scheme approved in this behalf by the Government of India in the Ministry of Petroleum and Natural Gas (hereinafter referred to as the Site Restoration Account), or

(ii) deposited any amount in an account opened by the assessee for the purposes specified in a scheme framed by the said Ministry,

the assessee shall be entitled to a deduction of —

- a sum equal to the sum deposited; or
- a sum equal to twenty per cent of its profits (as computed under the head "Profits and gains of business or profession" before making any deduction under the new section),

whichever is less.

(3) For this purpose, it is provided that any amount credited in the special account or Site Restoration Account by way of interest shall also be deemed to be a deposit.

(4) Non-eligibility - (i) Where such assessee is a firm or AOP or BOI, the deduction under this section will not be available in the computation of the income of any partner of the firm or the member of the AOP or BOI.

(ii) Where any deduction in respect of any amount deposited in the special account or Site Restoration Account has been allowed in any previous year, no deduction shall be allowed in respect of such amount in any other previous year.

(5) Audit - (i) Section 33ABA(2) provides that deduction under sub-section (1) shall not be admissible unless the accounts of the said business of the assessee for the previous year relevant to the assessment year have been audited by a chartered accountant and the assessee furnishes the report of such audit in the prescribed form along with the return.

(ii) Where the assessee is required by or under any other law to get his accounts audited, it will be sufficient compliance with the provisions of this sub-section if the assessee gets the accounts of the aforesaid business audited under any such law and furnishes the report of the audit and a further report in the prescribed form.

(6) Withdrawal of deduction - Any amount standing to the credit in the special account or the Site Restoration Account will not be allowed to be withdrawn except for the purposes specified in the scheme or in the deposit scheme.

No deduction shall be allowed in respect of any amount utilised for the purchase of the following items :

(a) any machinery or plant to be installed in any office premises or residential accommodation, including any accommodation in the nature of a guest house;

(b) any office appliances (not being computers);

(c) any machinery or plant, the whole of the actual cost of which is allowed as a deduction (whether by way of depreciation or otherwise) in computing the income chargeable under the head 'Profits and gains of business or profession' of any one previous year;

(d) any new machinery or plant to be installed in an industrial undertaking for the purpose of the business of construction, manufacture or production of any article or thing specified in the list in the Eleventh Schedule.

(7) Withdrawal on closure of account - (i) Where any amount standing to the credit of the assessee in the special account or in the Site Restoration Account is withdrawn on closure of the account during any previous year by the assessee, the amount so withdrawn from the account as reduced by the amount, if any, payable to the Central Government by way of profit or production share as provided in the agreement referred to in section 42, shall be deemed to be the profits and gains of business or profession of that previous year and shall accordingly be chargeable to income-tax as the income of that previous year.

(ii) Where any amount is withdrawn on closure of the account in a previous year in which the business carried on by the assessee in no longer in existence, these provisions will apply as if the business is in existence in that previous year.

(8) Utilisation from scheme not available as a deduction - When any amount standing to the credit of the assessee in the special account or in the Site Restoration Account business is utilised by the assessee for the purpose of any expenditure in connection with such business in accordance with the scheme or the deposit scheme such expenditure will not be allowed in computing the income chargeable under the head 'Profits and gains of business or profession'.

(9) Consequences of non-utilisation - Where any amount is released in the previous year by the State Bank of India or is withdrawn from the Site Restoration Account and is not utilised in accordance with the scheme or the deposit scheme, the whole of such amount or the part thereof shall be deemed to be the profits and gains of business and accordingly chargeable to income-tax as income of that previous year. This sub-section will not apply in a case where such amount is released in the event of death of an assessee, partition of a Hindu undivided family or liquidation of a company. These circumstances are provided in clauses (b), (c) and (e) of section 33AB(3).

(10) Consequences of sale or transfer - Where any asset acquired in accordance with the scheme or the deposit scheme is sold or otherwise transferred in any previous year by the assessee before the expiry of eight years from the end of the previous year in which such assets were acquired, such part of the cost of such asset as is relatable to the deduction allowed under section 33ABA(1) shall be deemed to be the profits and gains of business or profession of the previous year in which the asset is sold or otherwise transferred and shall accordingly be chargeable to income-tax as the income of that previous year.

This sub-section will not apply in the following cases:

(a) where the asset is sold or otherwise transferred by the assessee to the Government, a local authority, a corporation established by or under a Central, State or Provincial Act or a Government company as defined in section 617 of the Companies Act, 1956; or

(b) where the sale or transfer of the asset is made in connection with the succession of a firm by a company in the business or profession carried on by the firm as a result of which the firm sells or otherwise transfers to the company any asset and the scheme or the deposit scheme continues to apply to the company in the manner applicable to the firm, if the following conditions are satisfied;

  (i) all the properties of the firm relating to the business or profession immediately before the succession become the properties of the company;

  (ii) all the liabilities of the firm relating to the business or profession immediately before the succession become the liabilities of the company; and

  (iii) all the shareholders of the company were partners of the firm immediately before the succession.

6.32 Income Tax

Specified period - The Central Government may, by notification in the Official Gazette, direct that the deduction allowable under this section will not be allowed after such date as may be specified in such notification.

(vi) Reserves for Shipping Business [Section 33AC]

The tonnage tax scheme, introduced by insertion of Chapter XII-G in the Income-tax Act, provides for special provisions relating to taxation of income of shipping companies. Consequently, no deduction under section 33AC is allowable from. A.Y. 2005-06, where a shipping company has opted for the tonnage tax scheme.

(vii) Expenditure on Scientific Research [Section 35]

This section allows a deduction in respect of any expenditure on scientific research related to the business of assessee. The expression 'scientific research' as defined in section 43(4)(i) means activities for the extension of knowledge in the fields of natural or applied science including agriculture, animal husbandry or fisheries. A reference to expenditure incurred on scientific research would include all expenditure incurred for the prosecution or the provision of facilities for the prosecution of scientific research but does not include any expenditure incurred in the acquisition of rights in or arising out of scientific research. In particular, a reference to scientific research related to a business or a class of business would include (i) any scientific research which may lead to or facilitate an extension of that business or all the business of that class, as the case may be; (ii) any scientific research of a medical nature which has a special relation to the welfare of the workers employed in that business or all the business of that class, as the case may be.

(1) The deduction allowable under this section consists of -

(i) Revenue Expenditure:

(a) Any revenue expenditure incurred by the assessee himself on scientific research related to his business. Expenditure incurred within three years immediately preceding the commencement of the business on payment of salary to research personnel engaged in scientific research related to his business carried on by the taxpayer or on material inputs for such scientific research will be allowed as deduction in the year in which the business is commenced. The deduction will be limited to the amount certified by the prescribed authority.

(b) An amount equal to 1¼ times of any sum paid to a university, college or other institution or scientific research association which has as its object, the undertaking of scientific research to be used for scientific research provided that the university, college institution or association is approved for this purpose by the Central Government by notification in the Official Gazette.

The scope of the above deduction has been extended to cover expenditure on sponsored research carried out in the in-house research and development facilities of public companies. For the purpose, the expression "public sector company" means Government company as defined in section 617 of the Companies Act, 1956.

The payments so made to such institutions would be allowable irrespective of whether (i) the field of scientific research is related to the assessee's business or not, and (ii) the payment is of a revenue nature or of a capital nature.

(c) A sum equal to 1¼ times of any amount paid to a company to be used by it for scientific research [Clause (iia) of section 35(1)]

However, such deduction would be available only if the company is registered in India and has as its main object the scientific research and development. Further, it should be approved by the prescribed authority and should fulfill the other prescribed conditions.

A company approved under section 35(1)(iia) will not be entitled to claim weighted deduction of 150% under section 35(2AB). However, it can continue to claim deduction under section 35(1)(i) in respect of the revenue expenditure incurred on scientific research.

(d) A sum equal to 1¼ times of any amount paid to any university, college or other institution approved by the Central Government by notification in the Official Gazette to be used for research in any social science or statistical research.

(e) The applicant scientific research association, university, college or other institution shall be approved in accordance with the guidelines, in the manner and subject to such conditions as may be prescribed. The guidelines, manner (including application Forms) and conditions have since been prescribed vide notification bearing S.O. 1856 (E) dated 30.10.2006.

(f) The deduction would be available only if such association, university, college or other institution is for the time being approved in accordance with the guidelines, in the manner and subject to such conditions as may be prescribed.

(g) Further, it has been clarified that the deduction to which an assessee (i.e. donor) is entitled on account of payment of any sum to a scientific research association or university or college or other institution, shall not be denied merely on the ground that subsequent to payment of such sum by the assessee, the approval granted to any of the aforesaid entities is withdrawn.

(ii) Capital Expenditure:

Any expenditure of a capital nature related to the business carried on by the assessee would be deductible in full in the previous year in which it is incurred.

Capital expenditure prior to commencement of business - The *Explanation* added to sub-section (2) specifically provides that where any capital expenditure has been incurred prior to the commencement of the business the aggregate of the expenditure so incurred within the three years immediately preceding the commencement of the business shall be deemed to have been incurred in the previous year in which the business is commenced. Consequently, any capital expenditure incurred within three years before the commencement of business will rank for deduction as expenditure for scientific research incurred during the previous year.

6.34 Income Tax

Expenditure on land disallowed - No deduction will be allowed in respect of capital expenditure incurred on the acquisition of any land after 29-2-1984 whether the land is acquired as such or as part of any property.

For the above purpose the expression 'land' would include any interest in land and it shall be deemed to be acquired on the date on which the document purporting to transfer the land is registered under the Registration Act, 1908 and where the possession of any land has been obtained in part performance of a contract of the nature referred to in section 53A of the Transfer of Property Act, 1882, on the date on which such possession was obtained.

(2) If any question arises under this section as to whether, and if so, to what extent, any activity constitutes, or any asset is being used, for scientific research, the Board shall refer the question to—

(a) the Central Government, when such question relates to any activity under clauses (ii) and (iii) of sub-section (1) i.e. any scientific research, or any research in social science or statistical research carried on by a university, college or institution approved for this purpose, and its decision shall be final;

(b) the prescribed authority, when such question relates to any activity other than the activity specified in clause (a) above whose decision shall be final.

(3) Carry forward of deficiency - Capital expenditure incurred on scientific research which cannot be absorbed by the business profits of the relevant previous year can be carried forward to the immediately succeeding previous year and shall be treated as the allowance for that year. In effect, this means that there is no time bar on the period of carry forward. It shall be accordingly allowable for that previous year.

(4) No depreciation - Section 35(2)(iv) clarifies that no depreciation will be admissible on any capital asset represented by expenditure which has been allowed as a deduction under section 35 whether in the year in which deduction under section 35 was allowed or in any other previous year.

(5) Approval by Central Government - The Central Government by notification in the Official Gazette will approve such scientific research association, university, college or institution for the purpose of sections 35(1)(ii) and 35(1)(iii).

The scientific research association, university or college or other institution referred to in section 35(1)(ii) or (iii) shall make an application in the prescribed form and manner to the Central Government for the purpose of grant of approval or continuance thereof under these clauses.

The Central Government may call for such documents (including audited annual accounts) or information from the scientific research association etc. in order to satisfy itself about the genuineness of the activities of the research association.

Notification issued by the Central Government under these clauses shall at any time have effect for not more than three assessment years (including an assessment year or years commencing before the date on which such notification is issued), as may be specified in the Notification. This time limit is applicable in respect of a notification issued by the Central Government under clause (ii) or clause (iii) before 13.7.2006. Consequently, any notification issued on or after 13.7.2006 shall remain in force until approval granted to such entity is withdrawn.

In respect of an application received on or after 13.7.2006, every notification under clause (ii) or clause (iii) shall be issued or an order rejecting the application shall be passed before expiry of 12 months from the end of the month in which the application for approval was received by the Central Government.

(6) Application of section 41 - Section 41, *inter alia*, seeks to tax the profits arising on the sale of an asset representing expenditure of a capital nature on scientific research. Such an asset might be sold, discarded, demolished or destroyed, either after having been used for the purposes of business on the cessation of its use for the purpose of scientific research related to the business or without having been used for other purposes. In either case, tax liability could arise. In the first case, where the asset is sold, etc., after having been used for the purposes of the business, the moneys payable in respect of such asset together with the amount of scrap value, if any, could be brought to charge under section 41(1) the provisions of which are wide enough to cover such situations and to bring to tax that amount of deductions allowed in earlier years. It may be noted that in such cases, the actual cost of the concerned asset under section 43(1) read with explanation would be nil and no depreciation would be allowed by virtue of section 35(2)(iv).

Where the asset representing expenditure of a capital nature on Scientific Research is sold without having been used for other purposes, then the case would come under section 41(3) and if the proceeds of sale together with the total amount of the deductions made under section 35 exceed the amount of capital expenditure, the excess or the amount of deduction so made, whichever is less, will be charged to tax as income of the business of the previous year in which the sale took place.

(7) Sum paid to National Laboratory, etc. [Section 35(2AA)]- Sub-section (2AA) of section 35 provides that any sum paid by an assessee to a National Laboratory or University or Indian Institute of Technology or a specified person for carrying out programmes of scientific research approved by the prescribed authority will be eligible for weighted deduction of one and one-fourth times of the amount so paid.

No contribution which qualifies for weighted deduction under this clause will be entitled to deduction under any other provision of the Act.

The authority which will approve the National Laboratory will also approve the programmes and procedure. Such programmes and procedure will be specified in rules.

The prescribed authority can call for each document or information as it considers necessary

to satisfy itself about the genuineness of scientific research activities of the National Laboratory applying for approval. The prescribed authority under Rules 6(3) to (7) is Secretary, Department of Scientific & Industrial Research/Director General (Income-tax *Exemptions).*

It has been clarified that the deduction to which an assessee is entitled on account of payment of any sum by him to a National Laboratory, University, Indian Institute of Technology or a specified person for the approved programme [referred to in sub-section (2AA) of section 35] shall not be denied to the donor-assessee merely on the ground that after payment of such sum by him, the approval granted to any of the aforesaid donee-entities has been withdrawn.

'National Laboratory' means a scientific laboratory functioning at the national level under the aegis of the Indian Council of Agricultural Research, Indian Council of Medical Research or the Council of Scientific and Industrial Research, the Defence Research and Development Organisation, the Department of Electronics, the Department of Bio-Technology, or the Department of Atomic Energy and which is approved as a National Laboratory by the prescribed authority in the prescribed manner. 'Specified person' means a person who is approved by the prescribed authority.

(8) Company engaged in Business of Drugs, Electronic Equipments, etc. [Section 35(2AB)]

Where a company engaged in the business of bio-technology or *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* incurs any expenditure on scientific research on inhouse research and development facility as approved by the prescribed authority, a deduction of a sum equal to one and one-half times of the expenditure will be allowed. Such expenditure should not be in the nature of cost of any land or building.

For this clause, "expenditure on scientific research" in relation to drugs and pharmaceuticals shall include expenditure incurred on clinical drug trial, obtaining approval from any state regulatory authority, and filing an application for a patent under the Patents Act, 1970.

No deduction will be allowed in respect of the above expenditure under any other provision of this Act.

No company will be entitled to this deduction unless it enters into an agreement with the prescribed authority for co-operation in such research and development facility and for audit of accounts maintained for that facility.

The prescribed authority shall submit its report in relation to the approval of the said facility to the Director General in such form and within such time as may be prescribed.

No deduction shall be allowed in respect of such expenditure incurred after 31-3-2012.

(9) Prescribed Authority - Rule 6 of the Income-tax Rules specifies the 'prescribed authority' for the purpose of section 35, in relation to research in the field of agriculture, animal

husbandry and fisheries, medical sciences, social sciences or statistical research and other natural or applied science. The expression "prescribed authority", for this purpose refers to the Indian Council of Agricultural Research, the Indian Council of Medical Research or the Indian Council of Social Science Research or the Secretary, Department of Science and Technology, Government of India or any other officer of the Department nominated by him in this behalf as may be appropriate to the nature of the scientific research in question of Rule 6.

(viii) Expenditure for obtaining licence to operate telecommunication services [Section 35ABB]: (1) Where any capital expenditure has been incurred for acquiring any right to operate telecommunication services and for which payment has actually been made to obtain a licence, a deduction will be allowed in equal annual instalments over the relevant previous years.

"Relevant previous years" means—

(a) in a case where the licence fee is actually paid before the commencement of the business to operate telecommunication services, the previous years beginning with the previous year in which such business commenced;

(b) in any other case, the previous years beginning with the previous year in which the licence fee is actually paid, and the subsequent previous year or years during which the licence, for which the fee is paid, shall be in force.

"Payment has actually been made" means the actual payment of expenditure irrespective of the previous year in which the liability for the expenditure was incurred according to the method of accounting regularly employed by the assessee.

(2) Moreover, any capital expenditure so incurred before the actual commencement of the business shall also be eligible for deduction under sub-section (1).

(3) Where the licence is transferred and the proceeds of the transfer (so far as they consist of capital sums) are less than the expenditure incurred remaining unallowed, a deduction equal to such expenditure remaining unallowed, as reduced by the proceeds of the transfer, shall be allowed in respect of the previous year in which the licence is transferred.

(4) Where the whole or any part of the licence is transferred and the proceeds of the transfer (so far as they consist of capital sums) exceed the amount of the expenditure incurred remaining unallowed, so much of the excess as does not exceed the difference between the expenditure incurred to obtain the licence and the amount of such expenditure remaining unallowed shall be chargeable to income-tax as profits and gains of the business in the previous year in which the licence has been transferred.

Where the licence is transferred in a previous year in which the business is no longer in existence, the above provisions will apply as if the business is in existence in that previous year.

(5) Where the whole or any part of the licence is transferred and the proceeds of the transfer (so far as they consist of captial sums) are not less than the amount of expenditure incurred remaining unallowed, no deduction for such expenditure shall be allowed in respect of the previous year in which the licence is transferred or in any subsequent previous year.

(6) Where a part of the licence is transferred in a previous year, the proceeds of transfer will be subtracted from the expenditure remaining unallowed. Such remainder will be divided by the number of relevant previous years which have not expired at the beginning of the previous year during which the licence is transferred.

(7) Where in a scheme of amalgamation the amalgamating company sells or otherwise transfers the licence to the amalgamated company being an Indian company, the above provisions with regard to the chargeability of the surplus will not apply to the amalgamating company. Further, the provisions will apply to the amalgamated company as they would have applied to the amalgamating company if the latter had not transferred the licence.

(8) The said provisions relating to transfer of licence given in (iii), (iv) and (v) above shall not be applicable in the case of demerged company where the demerged company sells or transfers the licence to the resulting company (being an Indian company) and the provisions of the section allowing deduction of expenditure incurred for obtaining the licence shall be applicable to the resulting company as it would have applied to demerged company.

(9) Where a deduction is claimed and allowed for any previous year under sub-section (1) of the section 35ABB, then, no deduction on the capital expenditure so incurred shall be allowed by way of depreciation under sub-section (1) of section 32 in respect of acquiring any right to operate telecommunication services.

(ix) Promotion of social and economic welfare [Section 35AC] – (1) Under this section, deduction will be allowed in computing profits of business or profession chargeable to tax, in respect of the expenditure incurred for an eligible project or scheme for promoting social and economic welfare or uplift of the public as may be specified by the Central Government on the recommendations of the "National Committee". For this purpose, 'National Committee' will be the committee constituted by the Central Government from amongst persons of eminence in public life. Rules 11-F to 11-O deal with the National Committee for Promotion of Social and Economic Welfare and the guidelines for granting approval of associations and institutions and for recommending projects or schemes, for the purposes of this provision.

(2) The deduction will be allowed in case where the qualifying expenditure is either incurred by way of payment to a public sector company, a local authority or to an approved association or institution for carrying out any eligible project or scheme.

(3) However, companies will be allowed the deduction also in cases where expenditure is incurred by them directly on an eligible project or scheme.

(4) The claim for deduction under this section should be supported by a certificate obtained from the public sector company, local authority or approved association or institution as the case may be. Where the claim is in respect of expenditure directly incurred by a company on an eligible project or scheme, a certificate should be obtained from a Chartered Accountant.

(5) The deduction to which an assessee (i.e. the donor) is entitled on account of payment of any sum by him to a public sector company or a local authority or to an association or institution shall not be denied to the assessee merely on the ground that after payment of such sum by him, the approval granted to such association or institution has been withdrawn or the notification notifying the eligible project or scheme referred to in section 35AC has been withdrawn.

(6) The Committee can withdraw the approval to an association or institution if it is satisfied that the project or the scheme is not being carried on in accordance with all or any of the conditions subject to which approval was granted or if the association/institution has failed to furnish to the National Committee, after the end of each financial year, a progress report within the prescribed time in the prescribed form. The National Committee, should however, give a reasonable opportunity to the concerned association or institution of showing cause against the proposed withdrawal. Further, a copy of the order withdrawing the approval or notification should be forwarded to the Assessing Officer having jurisdiction over the concerned association or institution.

(7) Similarly, the Committee can withdraw a notification regarding an eligible project or scheme if it is satisfied that the project or the scheme is not being carried out in accordance with all or any of the conditions subject to which such project or scheme was notified or a report in respect of such eligible project or scheme has not been furnished after the end of each financial year, in the prescribed form within the prescribed time. The National Committee should however, give a reasonable opportunity of showing cause against the proposed withdrawal.

(8) Further, a copy of the notification by which the eligible project or scheme is withdrawn should be forwarded to the Assessing Officer having jurisdiction over the concerned association, institution, public sector company or local authority, as the case may be, carrying on such eligible project or scheme.

(i) Where the approval of the National Committee or the notification in respect of eligible project or scheme is withdrawn in case of a public sector company or local authority, etc; or

(ii) Where a company has claimed deduction in respect of any expenditure incurred directly on the eligible project or scheme and the approval for such project or scheme is withdrawn by the National Committee,

the total amount of payment received by the public sector company or the local authority, etc., as case may be, in respect of which it has furnished to certificate, or the deduction claimed by

the company shall be deemed to be the income of such company/authority, etc. for previous year in which the approval or notification is withdrawn. Further, tax will be charged on such income at the maximum marginal rate in force.

(x) Introduction of "investment-linked tax incentives" for specified businesses [New Section 35AD]

(i) Although there are a plethora of tax incentives available under the Income-tax Act, they do not fulfill the intended purpose of creating infrastructure since these incentives are linked to profits and consequently have the effect of diverting profits from the taxable sector to the tax-free sector. Therefore, with the specific objective of creating rural infrastructure and environment friendly alternate means for transportation of bulk goods, investment-linked tax incentives have been introduced for specified businesses, namely, –

- *setting-up and operating 'cold chain' facilities for specified products;*
- *setting-up and operating warehousing facilities for storing agricultural produce;*
- *laying and operating a cross-country natural gas or crude or petroleum oil pipeline network for distribution, including storage facilities being an integral part of such network.*

(ii) 100% of the capital expenditure incurred during the previous year, wholly and exclusively for the above businesses would be allowed as deduction from the business income. However, expenditure incurred on acquisition of any land, goodwill or financial instrument would not be eligible for deduction.

(iii) Further, the expenditure incurred, wholly and exclusively, for the purpose of specified business prior to commencement of operation would be allowed as deduction during the previous year in which the assessee commences operation of his specified business. A condition has been inserted that such amount incurred prior to commencement should be capitalized in the books of account of the assessee on the date of commencement of its operations.

(iv) The specified business should fulfill the following conditions -

(1) it should not be set up by splitting up, or the reconstruction, of a business already in existence;

(2) it should not be set up by the transfer to the specified business of machinery or plant previously used for any purpose;

In order to satisfy this condition, the total value of the plant or machinery so transferred should not exceed 20% of the value of the total plant or machinery used in the new business.

For the purpose of this condition, machinery or plant would not be regarded as previously used if it had been used outside India by any person other than the assessee provided the following conditions are satisfied:

(a) such plant or machinery was not used in India at any time prior to the date of its installation by the assessee;

(b) the plant or machinery was imported into India from a foreign country;

(c) no deduction in respect of depreciation of such plant or machinery has been allowed to any person at any time prior to the date of installation by the assessee.

(3) In respect of the business of laying and operating a cross-country natural gas or crude or petroleum oil pipeline network for distribution, including storage facilities being an integral part of such network, such business,—

(a) should be owned by a company formed and registered in India under the Companies Act, 1956 or by a consortium of such companies or by an authority or a board or a corporation established or constituted under any Central or State Act;

(b) should have been approved by the Petroleum and Natural Gas Regulatory Board and notified by the Central Government in the Official Gazette.

(c) should have made not less than one-third of its total pipeline capacity available for use on common carrier basis by any person other than the assessee or an associated person; and

(d) should fulfill any other prescribed condition.

(v) The assessee shall not be allowed any deduction in respect of the specified business under the provisions of Chapter VI-A under the heading "C – Deductions in respect of certain incomes".

(vi) The assessee cannot claim deduction in respect of such expenditure incurred for specified business under any other provision of the Income-tax Act in the current year or under this section for any other year.

(vii) The benefit will be available –

(a) in a case where the business relates to laying and operating a cross country natural gas pipeline network for distribution, if such business commences its operations on or after the 1st April, 2007; and

(b) in any other case, if such business commences its operation on or after the 1st April, 2009.

Consequently, profit-linked deduction provided under section 80-IA to the business of laying and operating a cross country natural gas distribution network has been discontinued. As a result, any person availing of this incentive can now avail of the benefit under section 35AD.

(viii) For the previous year 2009-10, an assessee carrying on the business of laying and operating a cross country natural gas pipeline network for distribution, including storage facilities being an integral part of such network, would be allowed a deduction of 100% of the capital expenditure (other than on land, goodwill and financial instrument) incurred during any earlier previous year, if the business has commenced operation between 1.4.2007 and 31.3.2009. This will be available in addition to any other capital expenditure (excluding land, goodwill and financial instrument) incurred during the previous year 2009-10. However, no deduction for such amount should have been allowed or allowable to the assessee in any earlier previous year.

(ix) "Cold chain facility" means a chain of facilities for storage or transportation of agricultural and forest produce, meat and meat products, poultry, marine and dairy products, products of horticulture, floriculture and apiculture and processed food items under scientifically controlled conditions including refrigeration and other facilities necessary for the preservation of such produce.

An "associated person" in relation to the assessee means a person—

(1) who participates directly or indirectly or through one or more intermediaries in the management or control or capital of the assessee;

(2) who holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in the capital of the assessee;

(3) who appoints more than half of the Board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of the assessee; or

(4) who guarantees not less than 10% of the total borrowings of the assessee.

(x) ***Example***

A Ltd. commenced operations of the business of laying and operating a cross-country natural gas pipeline network for distribution on 1st April, 2009. The company incurred capital expenditure of Rs.40 lakh during the period January to March, 2009 exclusively for the above business, and capitalized the same in its books of account as on 1st April, 2009. Further, during the financial year 2009-10, it incurred capital expenditure of Rs.150 lakh (out of which Rs.50 lakh was for acquisition of land) exclusively for the above business. Compute the deduction under section 35AD for the A.Y.2010-11, assuming that A Ltd. has fulfilled all the conditions specified in section 35AD.

The amount of deduction allowable under section 35AD for A.Y.2010-11 would be –

Particulars	***Rs.***
Capital expenditure incurred during the P.Y.2009-10 (excluding the expenditure incurred on acquisition of land) = Rs.150 lakh – Rs.50 lakh	*100 lakh*
Capital expenditure incurred prior to 1.4.2009 (i.e., prior to commencement of business) and capitalized in the books of account as on 1.4.2009	*40 lakh*
Total deduction under section 35AD for A.Y.2010-11	***140 lakh***

(xi) Where any goods or services held for the purposes of the specified business are transferred to any other business carried on by the assessee, or vice versa, and if the consideration for such transfer does not correspond with the market value of the goods or services then the profits and gains of the specified business shall be computed as if the transfer was made at market value.

For the above purpose, "market value" means the price such goods or services would ordinarily fetch in the open market, subject to statutory or regulatory restrictions, if any.

(xii) The deduction shall be allowed to the assessee only if the accounts of the assessee for the relevant previous year have been audited by a chartered accountant and the assessee furnishes the audit report in the prescribed form, duly signed and verified by such accountant along with his return of income.

(xiii) Where it appears to the Assessing Officer that the assessee derives more than ordinary profits from the specified business due to close connection between the assessee and any other person, or due to any other reason, the Assessing Officer may consider such profits as may be reasonably deemed to have been derived from the specified business for the purpose of computing deduction under this section.

(xi) Contributions for Rural Development [Section 35CCA]

This section allows a deduction of the following expenditure incurred by the assessee during the previous year:

(1) Payment to an association or institution, having the objective of undertaking programmes of rural development. Such payment must be used for carrying out any programme of rural development approved by the prescribed authority.

Conditions for Allowance

(a) The assessee must furnish a certificate from such association (which should be authorised by the prescribed authority to issue such a certificate) that the programme of rural development had been approved by the prescribed authority before 1-3-1983 and

(b) Where such payment is made after 28-2-1983, the programme should involve work by way of (i) construction of any building, or other structure (to be used for dispensary, school, training or welfare centre, workshop, etc.) or (ii) the laying of any road or (iii) the construction or boring of a well or tube well or (iv) the installation of any plant or machinery and such work must have commenced before 1-3-1983.

(2) Payment to an association or institution having as its object the training of persons for implementing rural development programme.

Conditions:

(a) Assessee must furnish a certificate from such association (which should be authorised by the prescribed authority to issue such a certificate) that it has been approved by the prescribed authority before 1-3-1983.

(b) Such training of persons must have started before 1-3-1983.

The deduction to which an assessee is entitled on account of payment of any sum by him to an association or institution for carrying out the programme of rural development shall not be denied to the assessee merely on the ground that after payment of such sum by him, the approval granted to such programme or, as the case may be, to the association or institution has been withdrawn.

(3) Payment to a rural development fund set up and notified by the Central Government.

The expression 'programme of rural development' for this purpose have the same meaning as has been assigned to it under Explanation to section 35CC(i).

(4) Payments made to "National Urban Poverty Eradication Fund" (NUPEF) set up and notified by the Central Government.

It has been specifically provided that in every case where any deduction in respect of contribution for rural development is claimed by the assessee and allowed to him for any assessment year in respect of any expenditure incurred by way of payment of contribution to the approved association or institution, no deduction in respect of the same expenditure can again be claimed by the assessee under any other relevant provision.

(xii) Amortisation of Preliminary Expenses [Section 35D]– (1) Section 35D provides for the amortisation of preliminary expenses incurred by Indian companies and other resident non-corporate taxpayers for the establishment of business concerns or the expansion of the business of existing concerns.

(2) This section applies (a) only to Indian companies and resident non-corporate assessees; (b) in the case of new companies to expenses incurred before the commencement of the business; (c) in the case of extension of an existing undertaking to expenses incurred till the extension is completed, i.e., in the case of the setting up of a new unit - to expenses incurred till the new unit commences production or operation.

(3) Such preliminary expenditure incurred shall be amortised over a period of 5 years. In other words, 1/5th of such expenditure is allowable as a deduction for each of the five successive previous years beginning with the previous year in which the business commences or, the previous year in which the extension of the undertaking is completed or the new unit commences production or operation, as the case may be.

(4) Eligible expenses - The following expenditure are eligible for amortisation:

(i) Expenditure in connection with - (a) the preparation of feasibility report (b) the preparation of project report; (c) conducting market survey or any other survey necessary for the business of the assessee; (d) engineering services relating to the assessee's business; (e) legal charges for drafting any agreement between the assessee and any other person for any purpose relating to the setting up to conduct the business of assessee.

(ii) Where the assessee is a company, in addition to the above, expenditure incurred - (f) by way of legal charges for drafting the Memorandum and Articles of Association of the company; (g) on printing the Memorandum and Articles of Association; (h) by way of fees for registering the company under the Companies Act; (i) in connection with the issue, for public subscription, of the shares in or debentures of the company, being underwriting commission, brokerage and charges for drafting, printing and advertisement of the prospectus; and

(iii) Such other items of expenditure (not being expenditure qualifying for any allowance or deduction under any other provision of the Act) as may be prescribed by the Board for the purpose of amortisation. However, the Board, so far, has not prescribed any specific item of expense as qualifying for amortisation under this clause.

In the case of expenditure specified in items (a) to (e) above, the work in connection with the preparation of the feasibility report or the project report or the conducting of market survey or any other survey or the engineering services referred to must be carried out by the assessee himself or by a concern which is for the time being approved in this behalf by the Board.

(5) Overall Limits - The maximum aggregate amount of the qualifying expenses that can be amortised has been fixed at 5% of the cost of the project or in the case of an Indian company, or, at the option of the company, 5% of the capital employed in the business of the company, whichever is higher. The excess, if any, of the qualifying expenses shall be ignored.

The assessee is entitled to a deduction of an amount equal to one-fifth of the qualifying amount of the expenditure for each of the five successive accounting years beginning with the year in which the business commences, or as the case may be, the previous year in which the business commences or as the case may be, the previous year in which extension of the undertaking is completed or the new unit commences production or operation.

(6) For purpose of amortisation, the expression, '**cost of the project**' means -

6.46 Income Tax

(i) In the case of expenses incurred before the commencement of business the actual cost of the fixed assets, being land, buildings, leaseholds, plant, machinery, furniture, fittings, railway sidings (including expenditure on the development of land, buildings) which are shown in the books of the assessee as on the last day of the previous year in which the business of the assessee commences;

(ii) in case of extension of the business or setting up of a new unit, the cost of the fixed assets being land, buildings, leaseholds, plant, machinery, furniture, fittings, and railway sidings (including expenditure on the development of land and buildings) which are shown in the books of the assessee as on the last day of the previous year in which the extension of the undertaking is completed or, as the case may be, the new unit commences production or operation, insofar as such assets have been acquired or developed in connection with the extension of the undertaking or the setting up of the new unit.

(7) The expression **"capital employed in the business of the company"** must be taken to mean -

(i) in the case of new company, 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;

(ii) in the case of extension of the business or the setting up of a new unit, the aggregate of the issued share capital, debentures, and long-term borrowings as on the last day of the accounting year in which the extension of the undertaking is completed or, as the case may be, the unit commences production or operation insofar as such capital, debentures and long-term borrowings have been issued or obtained in connection with the extension of the undertaking or the setting up of the new undertaking or the setting up of the new unit of the company.

(8) The expression "long-term borrowing," mentioned above, means any moneys borrowed in India by the company from the Government or the Industrial Finance Corporation of India or the Industrial Credit and Investment Corporation of India or any other financial institution eligible for deduction under section 36(1)(iii) or any banking institution, or any moneys borrowed or debt incurred by it in a foreign country in respect of the purchase outside India of plant and machinery where the terms under which such moneys are borrowed or the debt is incurred provide for the repayment thereof during a period of not less than seven years.

(9) In cases where the assessee is a person other than a company or a co-operative society, the deduction would be allowable only if the accounts of the assessee for the year or years in which the expenditure is incurred have been audited by a Chartered Accountant and the assessee furnishes, along with his return of income for the first year in respect of which the deduction is claimed, the report of such audit in the prescribed form duly signed and verified by the auditor and setting forth such other particulars as may be prescribed.

(10) Special provisions for amalgamation and demerger

Where the undertaking of an Indian company is transferred, before the expiry of the period of ten years, to another Indian company under a scheme of amalgamation as defined in section 2(IA) the aforesaid provisions will apply to the amalgamated company as if the amalgamation had not taken place. But no deduction will be admissible in the case of the amalgamating company for the previous year in which the amalgamation takes place.

Sub-section (5A) provides similar provisions for the scheme of demerger where the resulting company will be able to claim amortisation of preliminary expenses as if demerger had not taken place, and no deduction shall be allowed to the demerged company in the year of demerger.

It has been clarified that in case where a deduction under this section is claimed and allowed for any assessment year in respect of any item of expenditure, the expenditure in respect of which deduction is so allowed shall not qualify for deduction under any other provision of the Act for the same or any other assessment year.

(xiii) Amortisation of Expenses for Amalgamation/Demerger [Section 35DD]

(1) Where an assessee, being an Indian company, incurs expenditure on or after 1st April, 1999, wholly and exclusively for the purpose of amalgamation or demerger, the assessee shall be allowed a deduction equal to one-fifth of such expenditure for five successive previous years beginning with the previous year in which amalgamation or demerger takes place.

(2) No deduction shall be allowed in respect of the above expenditure under any other provisions of the Act.

(xiv) Amortisation of expenditure incurred under voluntary retirement scheme [Section 35DDA]- (1) This section applies to an assessee who has incurred expenditure in any previous year in the form of payment to any employee in connection with his voluntary retirement, in accordance with any scheme or schemes of voluntary retirement.

(2) The amount of deduction allowable is one-fifth of the amount paid for that previous year, and the balance in four equal installments in the four immediately succeeding previous years.

(3) In case of amalgamation, demerger, reorganisation or succession of business during the intervening period of the said 5 years, the benefit of deduction will be available to the "new company" for the balance period including the year in which such amalgamation/demerger/reorganisation or succession takes place.

(4) This will be applicable in the following situations:

(i) where an Indian company is transferred to another Indian company in a scheme of amalgamation;

(ii) where the undertaking of an Indian company is transferred to another company in a scheme of demerger;

(iii) where due to a re-organisation of business, a firm is succeeded by a company fulfilling the conditions in section 47(xiii) or a proprietary concern is succeeded by a company fulfilling the conditions in section 47(xiv).

(5) In the above cases, the deduction shall be available to the successor company as such deduction would have applied to the original entity if such transfer had not taken place at all.

(6) It is further provided that no deduction shall be available to the original entity being the amalgamating company, or the demerged company or the firm or proprietary concern (as the case may be) for the previous year in which the amalgamation, demerger or succession takes place.

(7) No deduction shall be allowed in respect of the above expenditure under any other provision of the Act.

(xv) Amortisation of expenses for prospecting and development of certain minerals [Section 35E] – (1) This provision applies only to expenditure incurred by an Indian company or any other person who is resident in India. Thus, foreign companies or foreign concerns and non-resident assessees are not entitled for the benefits of deduction under section 35E. In order to qualify for amortisation, the assessee should be engaged in any operations relating to prospecting for or the extraction or production of any mineral.

(2) Eligible expenses - The nature and kind of expenditure qualifying for amortisation are - (i) It must have been incurred during the year of commercial production or any one or more of the four years immediately preceding that year, (ii) It must be an expenditure incurred wholly and exclusively on any operations relating to the prospecting for or extraction of certain minerals listed in the Seventh Schedule of the Income-tax Act.

(3) Expenditure not allowed for deduction - However, any portion of the expenditure which is met directly or indirectly by any other persons or authority and the sale, salvage, compensation or insurance moneys realised by the assessee in respect of any property or rights brought into existence as a result of the expenditure should be excluded from the amount of expenditure qualifying for amortisation. Further, specific provision has been made to the effect that the following items of expenses do not qualify for amortisation at all viz.:

(i) Expenditure incurred on the acquisition of the site of the source of any minerals or group of associated minerals stated above or of any right in or over such site;

(ii) Expenditure on the acquisition of the deposits of minerals or group of associated minerals referred to above or to any rights in or over such deposits; or

(iii) Expenditure of a capital nature in respect of any building, machinery, plant or furniture for which depreciation allowance is permissible under section 32.

(4) Amount of deduction - The assessee will be allowed for each of ten relevant previous years, a deduction of an amount equal to one-tenth of the aggregate amount of the qualifying expenditure. Thus, the deduction to be allowed for any relevant previous year is (i) one-tenth of the expenditure or (ii) such amount as will reduce to nil the income of the previous year arising from the commercial exploration of any minerals or other natural deposit of the mineral or minerals in a group of associated minerals in respect of which the expenditure was incurred, whichever figure is less. The amount of the deduction admissible in respect of any relevant previous year to the extent to which it remains unallowed, shall be carried forward and added to the installment relating to the previous year next following and shall be deemed to be a part of the installment and so on, for ten previous years beginning from the year of commercial production.

(5) For purposes of this amortisation, the expression "operation relating to prospecting" means any operation undertaken for the purpose of exploiting, locating or proving deposits of any minerals and includes any such operation which proves to be infructuous or abortive. The expression 'year of commercial production' means the previous year in which as a result of any operation relating to prospecting or commercial production of any material or one or more of the minerals in a group of associated minerals specified in Part A or Part B, respectively, of the Seventh Schedule to Act actually commences. The relevant previous year in which the deduction would be allowed to the assessee are those ten previous years beginning with the year of commercial production.

(6) In the case of amalgamation, such deduction would continue to be admissible to the amalgamated company as if the amalgamation had not taken place.

Sub-section (7A) provides for similar provisions in cases of demerger where such deduction can be availed of by the resulting company as if the demerger had not taken place.

Further, no deduction will be admissible to the amalgamating/demerged company in the year of amalgamation/demergers.

(7) Where a deduction is claimed and allowed on account of amortisation of the expenses under section 35E in any year in respect of any expenditure, the expenditure in respect of which deduction is so allowed shall not again qualify for deduction from the profits and gains under any other provisions of the Act for the same or any other assessment year. The provisions with regard to audit of accounts relating to the qualifying expenditure are similar to those applicable for amortisation of preliminary expenses discussed earlier.

(xvi) Other Deductions [Section 36] - This section authorises deduction of certain specific expenses. The items of expenditure and the conditions under which such expenditures are deductible are:

(1) Insurance premia paid [Section 36(1)(i)] - If insurance policy has been taken out against risk, damage or destruction of the stock or stock of the business or profession, the premia paid is deductible. But the premium in respect of any insurance undertaken for any

other purpose is not allowable under the clause.

(2) Insurance premia paid by a Federal Milk Co-operative Society [Section 36(1)(ia)] - Deduction is allowed in respect of the amount of premium paid 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 supply of milk raised by its members to such Federal Milk Co-operative Society. The deduction is admissible without any monetary or other limits.

(3) Premia paid by employer for health insurance of employees [Section 36(1)(ib)] - This clause seeks to allow a deduction to an employer in respect of premia paid by him by any mode of payment other than cash to effect or to keep in force an insurance on the health of his employees in accordance with a scheme framed by (i) the General Insurance Corporation of India and approved by the Central Government; or (ii) any other insurer and approved by the IRDA.

(4) Bonus and Commission [Section 36(1)(ii)] - These are deductible in full provided the sum paid to the employees as bonus or commission shall not be payable to them as profits or dividends if it had not been paid as bonus or commission. It is a provision intended to safeguard against a private company or an association escaping tax by distributing a part of its profits by way of bonus amongst the members, or employees of their own concern instead of distributing the money as dividends or profits.

(5) Interest on borrowed capital [Section 36(1)(iii)] - In the case of genuine business borrowings, the department cannot disallow any part of the interest on the ground that the rate of interest is unreasonably high except in cases falling under section 40A.

Under section 36(1), deduction of interest is allowed in respect of capital borrowed for the purposes of business or profession in the computation of income under the head "Profits and gains of business or profession".

Capital may be borrowed for several purposes like for acquiring a capital asset, or to pay off a trading debt or loss etc. The scope of the expression ‘for the purposes of business’ is very wide. Capital may be borrowed in the course of the existing business as well as for acquiring assets for extension of existing business. Explanation 8 to section 43(1) clarifies that interest relatable to a period after the asset is first put to use cannot be capitalised. Interest in respect of capital borrowed for any period from the date of borrowing to the date on which the asset was first put to use should normally be capitalised. However, there was scope for the asssessees to claim it as a revenue expenditure.

It has now been provided that no such deduction shall be allowed in respect of any amount of interest paid, in respect of capital borrowed for acquisition of new 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. It is

significant to note here that even after the amendment the scope for claiming such interest as revenue expenditure in respect of existing business still exists.

(6) Discount on Zero Coupon Bonds(ZCBs) [Section 36(1)(iiia)] - Section 36(1)(iiia) provides deduction for the discount on ZCB on pro rata basis having regard to the period of life of the bond to be calculated in the manner prescribed. The Explanation seeks to provide the meaning of the expression 'discount' as a difference of the amount received or receivable by an infrastructure capital company/infrastructure capital fund/public sector company/ *scheduled bank* on issue of the bond and the amount payable by such company or fund *or bank* on maturity or redemption of the bond. The expression 'period of life of the bond' has been defined to mean the period commencing from the date of issue of the bond and ending on the date of the maturity or redemption.

For definitions of "infrastructure capital company" and "infrastructure capital fund", refer sections 2(26A) and 2(26B) in Chapter 1 of this study material – Basic Concepts.

(7) Contributions to provident and other funds [Section 36(1)(iv) and (v)] - Contribution to the employees' provident and other funds are allowable subject to the following conditions:

(a) The fund should be settled upon a trust.

(b) In case of Provident or a superannuation or a Gratuity Fund, it should be one recognised or approved under the Fourth Schedule to the Income-tax Act.

(c) The amount contributed should be periodic payment and not an adhoc payment to start the fund.

(d) The fund should be for exclusive benefit of the employees.

The nature of the benefit available to the employees from the fund is not material ; it may be pension, gratuity or provident fund.

(8) Amount received by assessee as contribution from his employees towards their welfare fund to be allowed only if such amount is credited on or before due date - Clause (va) of section 36(1) and clause (ia) of section 57 provide that deduction in respect of any sum received by the taxpayer as contribution from his employees towards any welfare fund of such employees will be allowed only if such sum is credited by the taxpayer to the employee's account in the relevant fund on or before the due date. For the purposes of this section, "due date" will mean the date by which the assessee is required as an employer to credit such contribution to the employee's account in the relevant fund under the provisions of any law on term of contract of service or otherwise.

As per paragraph 38 of the Employees Provident Funds Scheme, 1952, the amounts under consideration in respect of wages of the employees for any particular mouth shall be paid within 15 days of the close of every month. A further grace period of 5 days is allowed.

6.52 Income Tax

(9) Allowance for animals [Section 36(1)(vi)] - This clause grants an allowance in respect of animals which have died or become permanently useless. The amount of the allowance is the difference between the actual cost of the animals and the price realised on the sale of the animals themselves or their carcasses. The allowance under the clause would thus recoup to the assessee the entire capital expenditure in respect of animal.

(10) Bad debts [Section 36(1)(vii) and sub-section (2)] - These can be deducted subject to the following conditions:

(a) The debts or loans should be in respect of a business which was carried on by the assessee during the relevant previous year.

(b) The debt should have been taken into account in computing the income of the assessee of the previous year in which such debt is written off or of an earlier previous year or should represent money lent by the assessee in the ordinary course of his business of banking or money lending.

The proviso to the above sub-clause provides that in the case of banks to which clause (viia) applies, the amount of the deduction relating to any such debt or part thereof shall be limited to the amount by which such debt or part thereof exceeds credit balance in the provision for bad and doubtful debts account made under that clause. The scope of the above proviso has been expanded to cover any assessee and not only banks.

For the purpose of clause (vii) it has been clarified in the Act that any bad debt or part thereof written off as irrecoverable in the accounts shall not include any provision for bad and doubtful debts.

Further in the case of a claim for bad debts by an assessee covered by section 36(1)(viia), the bank or financial institution etc. should have debited the bad debt to the provision for bad and doubtful debts account.

Further, if on the final settlement the amount recovered in respect of any debt, where deduction had already been allowed, falls short of the difference between the debt due and the amount of debt allowed, the deficiency can be claimed as a deduction from the income of the previous year in which the ultimate recovery out of the debt is made. It is permissible for the Assessing Officer to allow deduction in respect of a bad debt or any part thereof in the assessment of a particular year and subsequently to allow the balance of the amount, if any, in the year in which the ultimate recovery is made, that is to say, when the final result of the process of recovery comes to be known.

Furthermore, where any bad debt has been written off as irrecoverable in the accounts of the previous year and the Assessing Officer is satisfied that such a debt or part thereof, in fact had become a bad debt in any earlier previous year not falling beyond a period of four previous years in which the debts should have been allowed provided the assessee accepts such a finding [Section 155(6)].

Recovery of a bad debt subsequently [Section 41(4)] - If a deduction has been allowed in respect of a bad debt under section 36, and subsequently the amount recovered in respect of such debt is more than the amount due after the allowance had been made, the excess shall be deemed to be the profits and gains of business or profession and will be chargeable as income of the previous year in which it is recovered, whether or not the business or profession in respect of which the deduction has been allowed is in existence at the time.

For example, let us assume that a debt of Rs.10,000 was claimed as a bad debt in the previous year 2008-09. However, the Assessing Officer allowed only a sum of Rs.5,000 as bad debt. If in the previous year 2009-10, a sum of Rs.4,000 is recovered ultimately in respect of the debt, then the Assessing Officer should allow a deduction in respect of the deficiency namely, Rs.1,000 i.e., the difference between the amount ultimately recovered and the amount disallowed earlier under Section 36(1)(vii). If on the other hand, the sum ultimately recovered is Rs.6,000 then there will be a liability, under section 41(4) in respect of sum of Rs.1,000, which would be deemed to be the profits and gains of business or profession. Such a liability under section 41(4) would arise even if the business or profession in respect of which deduction has been allowed is not in existence at that time.

(11) Special provision for bad and doubtful debts in cases of Rural Branches of Scheduled Banks [Section 36(1)(viia)]

(a) In the case of a scheduled bank which is not a bank incorporated by or under the laws of a country outside India or a non-scheduled bank, the following deductions will be allowed:

  (i) an amount not exceeding 7.5% of the total income (computed before making any deduction under this clause and Chapter VI-A), and

  (ii) an amount not exceeding 10% of the aggregate average advances made by the rural branches of such bank computed in the manner prescribed by the CBDT.

(b) A scheduled bank or a non-scheduled bank referred to in (a) above or a co-operative bank other than a primary agricultural credit society or a primary co-operative agricultural and rural development bank shall, at its option, be allowed a further deduction in excess of the limits specified in the foregoing provisions, for an amount not exceeding the income derived from redemption of securities in accordance with a scheme framed by the Central Government. It is also provided that this deduction shall not be allowed unless such income has been disclosed in the return of income under the head "Profits and gains of business or profession".

  Scheduled Bank : It refers to the State Bank of India or any of its subsidiaries or any of the nationalised banks and would also include any other bank which is listed in the Second Schedule to the Reserve Bank of India Act, 1935.

Non-Scheduled Bank : This refers to a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 which is not a scheduled bank.

Rural branch : This means a branch of a scheduled bank or a non-scheduled bank situated in a place which has a population of not more than 10,000 according to the last preceding census of which the relevant figures have been published before the first day of the previous year.

(c) **Foreign Banks** : In the case of foreign banks the deduction will be an amount not exceeding 5% of the total income (computed before making any deduction under this clause and Chapter VI-A).

(d) A public financial institution, a State Financial Corporation and a State Industrial Investment Corporation will be entitled to a deduction in respect of provision for bad and doubtful debts made out of profits. The maximum amount to be allowed as a deduction will be limited to 5% of its total income before making any deduction in respect of the provision for bad and doubtful debt or in respect of any deduction in Chapter VI-A.

"Public Financial Institution" shall have the meaning assigned to it in section 4A of the Companies Act.

"State Financial Corporation" means a financial corporation established under section 3 or section 3A or an institution notified under section 46 of the State Financial Corporations Act, 1951.

"State Industrial Investment Corporation" means a Government company within the meaning of Section 617 of the Companies Act engaged in the business of providing long-term finance for industrial projects and eligible for deduction under clause (viii) of this sub-section.

Co-operative bank, primary agricultural credit society and primary co-operative agricultural and rural development bank have the same meanings assigned in Explanation to section 80P(4).

(12) Special deduction to Specified Entities engaged in eligible business [Section 36(1)(viii)]

(a) This section provides deduction in respect of any special reserve created and maintained by a specified entity.

(b) The quantum of deduction, however, should not exceed 20% of the profits derived from eligible business computed under the head "Profits and gains of business or profession" carried to such reserve account.

(c) The eligible business for different entities specified are given in the table below –

	Specified entity	Eligible business
1.	Financial Corporation specified in section 4A of the Companies Act, 1956 Financial corporation which is a public sector company Banking company Co-operative bank (other than a primary agricultural credit society or a primary co-operative agricultural and rural development bank)	Business of providing long-term finance for - (i) industrial or agricultural development or (ii) development of infrastructure facility in India; or *(iii) development of housing in India.*
2.	A housing finance company	Business of providing long-term finance for the construction or purchase of houses in India for residential purposes.
3.	Any other financial corporation including a public company	Business of providing long-term finance for development of infrastructure facility in India.

(d) However, where the aggregate amount carried to such reserve account exceeds twice the amount of paid up share capital and general reserve, no deduction shall be allowed in respect of such excess.

(e) Infrastructure facility has been defined to mean -

(a) (1) an infrastructure facility as defined in the Explanation to clause (i) of sub-section (4) of section 80-IA i.e.

(i) a road including toll road, a bridge or a rail system;

(ii) a highway project including housing or other activities being an integral part of the highway project;

(iii) a water supply project, water treatment system, irrigation project, sanitation and sewerage system or solid waste management system; and

(iv) a port, airport, inland waterway or inland port or a navigational channel in the sea

(2) any other public facility of a similar nature as may be notified by the CBDT in this behalf in the Official Gazette and which fulfils the prescribed conditions;

(b) an undertaking referred to in clause (ii) or clause (iii) or clause (iv) of sub-section (4) of section 80-IA (i.e. an undertaking providing telecommunication services, an undertaking developing, developing and operating, maintaining and operating an

industrial park or SEZ notified by the Central Government, an undertaking generating, distributing or transmitting power); and

(c) an undertaking referred to in sub-section (10) of section 80-IB i.e. an undertaking developing and building housing projects approved by a local authority.

Conditions to be fulfilled by a public facility to be eligible to be notified as an infrastructure facility [Notification No.187/2006 dated 20.7.2006]

Rule 6ABAA has been inserted in the Income-tax Rules, 1962 which specifies the conditions to be fulfilled by a public facility to be eligible to be notified as an infrastructure facility in accordance with the provisions of clause (d) of the Explanation to clause (viii) of sub-section (1) of section 36. The conditions specified therein are -

(a) it is owned by a company registered in India or by a consortium of such companies or by an authority or a board or a corporation or any other body established or constituted under any Central or State Act;

(b) it has entered into an agreement with the Central Government or a State Government or a local authority or any other statutory body for (i) developing or (ii) operating and maintaining or (iii) developing, operating and maintaining a new infrastructure facility similar in nature to an infrastructure facility referred to in the Explanation to section 80-IA(4)(i);

(c) it has started or starts operating and maintaining such infrastructure facility on or after 1st April, 1995.

Notification of public facilities as infrastructure facility for the purpose of section 36(1)(viii) [Notification No. 188/2006, dated 20.7.2006]

The following public facilities have been notified by the CBDT as infrastructure facility for purposes of section 36(1)(viii)-

(1) Inland Container Depot and Container Freight Station notified under the Customs Act, 1962
(2) Mass Rapid Transit system
(3) Light Rail Transit system
(4) Expressways
(5) Intra-urban or semi-urban roads like ring roads or urban by-passes or flyovers
(6) Bus and truck terminals
(7) Subways
(8) Road dividers
(9) Bulk Handling Terminals which are developed or maintained or operated for development of rail system
(10) Multilevel Computerised Car Parking.

Deduction in respect of income from long-term finance for development of infrastructure facilities - The deduction will now be available also to approved financial corporations providing long-term finance for development of infrastructure facilities in India. For this purpose, the expression "infrastructure facility" shall have the meaning assigned to it in section 80-IA.

(13) Expenses on family planning [Section 36(1)(ix)] - Any expenditure of revenue nature bona fide incurred by a company for the purpose of promoting family planning amongst its employees will be allowed as a deduction in computing the company's business income; where, the expenditure is of a capital nature, one-fifth of such expenditure will be deducted in the previous year in which it was incurred and in each of the four immediately succeeding previous years. This deduction is allowable only to companies and not to other assessees. The assessee would be entitled to carry forward and set off the unabsorbed part of the allowance in the same way as unabsorbed depreciation. The capital expenditure on promoting family planning will be treated in the same way as capital expenditure for scientific research for purposes of dealing with the profit or loss on the sale or transfer of the asset including a transfer on amalgamation.

(14) Deduction for expenditure incurred by entities established under any Central, State or Provincial Act [Section 36(1)(xii)]

Any expenditure (not being in the nature of capital expenditure) incurred by a corporation or a body corporate, by whatever name called, if –

(a) it is constituted or established by a Central, State or Provincial Act;

(b) such corporation or body corporate is notified by the Central Government in the Official Gazette for this purpose having regard to the objects and purposes of the Act;

(c) the expenditure is incurred for the objects and purposes authorised by the Act under which it is constituted and established.

Accordingly, the Central Government has notified the Oil Industry Development Board for the purpose of deduction under section 36(1)(xii).

(15) Deduction in respect of banking cash transaction tax [Section 36(1)(xiii)]

(a) The Finance Act, 2005 has, through Chapter VII, introduced a tax called banking cash transaction tax, as an anti tax-evasion measure, in respect of every taxable banking transaction entered into on or after 1.6.2005, at the rate of 0.1% of the value of every such taxable banking transaction.

(b) Taxable banking transaction means -

(1) a transaction, being withdrawal of cash (by whatever mode) on any single day from an account (other than a savings bank account) maintained with any scheduled bank, exceeding, -

(i) Rs.50,000, in case such withdrawal is from the account maintained by any individual or HUF;

(ii) Rs.1,00,000, in case such withdrawal is from the account maintained by a person other than any individual or HUF; or

(2) A transaction, being receipt of cash from any scheduled bank on any single day on encashment of one or more term deposits, whether on maturity or otherwise, from that bank, exceeding -

(i) Rs.50,000, in case such term deposit or deposits are in the name of any individual or HUF;

(ii) Rs.1,00,000, in case such term deposit or deposits are by any person other than any individual or HUF.

(c) However, banking cash transaction tax is not leviable if the amount of term deposit or deposits is credited to any account with the bank.

(d) Section 36(1)(xiii) provides for deduction of any amount of banking cash transaction tax paid by the assessee during the previous year on the taxable banking transactions entered into by him.

Note – Banking Cash Transaction Tax is not chargeable in respect of any taxable banking transaction entered into on or after 1.4.2009.

(16) Deduction of contribution by a public financial institution to Credit guarantee fund trust for small industries [Section 36(1)(xiv)]

(i) Section 36(1)(xiv) provides for deduction of any sum paid by a public financial institution by way of contribution to such credit guarantee fund trust for small industries notified by the Central Government in the Official Gazette.

(ii) Public financial institution has the meaning assigned to it in section 4A of the Companies Act, 1956.

(17) Deduction of securities transaction tax paid [Section 36(1)(xv)]

The amount of securities transaction tax paid by the assessee during the year in respect of taxable securities transactions entered into in the course of business shall be allowed as deduction under section 36 subject to the condition that such income from taxable securities transactions is included under the head 'Profits and gains of business or profession'. Thus, securities transaction tax paid would be allowed as a deduction like any other business expenditure.

(xvii) Residuary Expenses [Section 37]

(1) Revenue expenditure incurred for purposes of carrying on the business, profession or vocation - This is a residuary section under which only business expenditure is allowable but not the business losses, e.g., those arising out of

embezzlement, theft, destruction of assets, misappropriation by employees etc. (These are allowable under section 29 as losses incidental to the business). The deduction is limited only to the amount actually expended and does not extend to a reserve created against a contingent liability.

(2) Conditions for allowance : The following conditions should be fulfilled in order that a particular item of expenditure may be deductible under this section :

(a) The expenditure should not be of the nature described in sections 30 to 36.

(b) It should have been incurred by the assessee in the accounting year.

(c) It should be in respect of a business carried on by the assessee the profits of which are being computed and assessed.

(d) It must have been incurred after the business was set up.

(e) It should not be in the nature of any personal expenses of the assessee.

(f) It should have been laid out or expended wholly and exclusively for the purposes of such business.

(g) It should not be in the nature of capital expenditure. (The principles to be followed for distinguishing capital expenditure from revenue are discussed below.)

(h) The expenditure should not have been incurred by the assessee for any purpose which is an offence or is prohibited by law.

This section is thus limited in scope. It does not permit an assessee to make all deductions which a prudent trader would make in ascertaining his own profit. It might be observed that the section requires that the expenditure should be wholly and exclusively laid out for purpose of the business but not that it should have been necessarily laid out for such purpose. There fore, expenses wholly and exclusively laid out for the purpose of trade are, subject to the fulfilment of other conditions, allowed under this section even though the outlay is unnecessary.

(3) For determining whether an expenditure is of the nature contemplated by the foregoing provisions of law the following tests should be applied:

(i) **'Character as a trader':** The expenditure should be incurred by the assessee in his character as a trader.

(ii) **'Voluntarily expended on grounds of commercial expediency' :** A sum of money expended, not out of necessity but with a view to getting a direct and immediate benefit to the trade, but voluntarily and on the grounds of commercial expediency and in order indirectly to facilitate the carrying on of the business may yet be expended wholly and exclusively for purposes of the trade [*Atherton v British Insulated and Helsby Ltd.* 10 LTC. 115 (H.L.)].

(iii) **'Direct concern and direct purpose' :** In order to ascertain whether the expenditure has been incurred wholly and exclusively for the purpose of the business one must look to the direct concern and direct purpose for which the money is laid out and not the remote or indirect result which may possibly motivate or flow from the expenditure.

(iv) **'Purpose of the assessee's own business' :** The expenditure should be primarily incurred for the assessee's own business. Notwithstanding this proposition so long as the expenditure is for the whole and exclusive purpose of the assessee's trade the mere fact that the expenditure incidentally obtains some advantage to the assessee in some character other than that of a trader, would not detract the effect of the finding that the expenditure was wholly and exclusively incurred for purpose of the assessee's business.

(v) **'Unremunerative expenditure' :** The expenditure need not be incurred solely for the purpose of earning profit in the year of account. For example, the cost of repairs or advertisement or expenses on a foreign tour by the managing directors would be deductible even though the income therefrom would be earned in future years.

(vi) **'Treatment in assessee's accounts' :** The way in which an item of expenditure is treated in the assessee's accounts is not a conclusive evidence against or in favour of the assessee.

Payment out of profits and payments ascertained by reference to profits : When a trader makes a payment which is computed in relation to profits the question that arises is : Does the payment represent a mere division of profit with another person or is it an item of expenditure the amount of which is ascertained by reference to the profits? The payment would be allowable in the second case but not in the first.

(4) Distinction between capital and revenue expenditure : The line of demarcation between capital and revenue expenditure is very thin and the ultimate conclusion on the nature of the expenditure is always a mixed question of law and fact. In deciding whether an expenditure is of a revenue or a capital nature, one must take into consideration the nature and ordinary course of the business of the assessee and the object for which the expenditure had been incurred.

Whether a particular item of expenditure is incurred for the purpose of the business or not must be viewed in the larger context of business necessity and expediency. For this purpose, one must look not to the documents but also the surrounding circumstances so as to arrive at a decision as to what exactly is the real nature of the transaction from the commercial point of view.

It is often very difficult to lay down a test of a comprehensive nature which would be of universal application. Different tests have to be applied from the business point of view and then conclusions must be arrived at on the question whether, on a fair consideration of the whole situation as evident from the facts, the expenditure in question incurred in a particular case is of revenue nature or of a capital nature. The following broad principles have been

evolved by the decisions of the various courts from time to time. These principles are neither exhaustive nor are they intended to be. They would serve only as guidelines to decide any problem arising in regard to the determination of the capital or revenue of a particular item [*Hylam Ltd. v CIT* [1913] 87 ITR 310 (A.P.)].

(i) If the expenditure is for the initial outlay or for acquiring or bringing into existence any asset or advantage of an enduring benefit to the business of the assessee or for extension of the business which is already in existence or for substantial replacement of any existing business asset it must be treated as capital expenditure. The Supreme Court has reiterated the above principle in *CIT v. Jalan Trading Co. (P) Ltd. [1985] 23 Taxman (SC).*

(ii) If, however, the expenditure, although incurred for the purpose of the business that too for acquiring an asset or advantage, is for running the business or for working out that asset with a view to producing profits, it would be a revenue expenditure. The expenditure incurred for the purpose of carrying on the business undertaking would be of a revenue nature. The expenditure which has to be incurred by an assessee in the ordinary course of his business, to enable him to carry on his trading operations is normally to be considered to be of a revenue nature. The expenditure by the assessee cannot be considered to be capital in nature merely because of the fact that the amount involved is large. The quantum of the expenditure cannot go to affect or alter the real nature and character of expenditure.

(iii) In cases where the outgoing of money spent by the assessee is so related to the carrying on or the conduct of the business that it may be regarded as an integral part of the profit-earning process of operations and not for the acquisition of any asset of a permanent character the possession of which is a condition precedent to the running of the business, then such an item of payment would constitute an expenditure of a revenue nature.

(iv) Any special knowledge, technical know-how or patent or trade mark constitutes an asset and if such an asset is acquired on payment for its use and exploitation for a limited period in the business and the acquisition is not of an asset or advantage of an enduring nature and at the end of the stipulated period the asset or advantage reverts back intact to the giver of the special knowledge or the owner of the patent, trade mark or copyright, it would constitute an expenditure of a revenue nature. In this context, it may be noted that a payment made to ward off competition in business to a rival would constitute a capital expenditure if the object of making that payment is to derive an advantage by eliminating competition over some length of time. The same result would not follow if there is no certainty of the duration of the advantage and the same can be put to an end at any point of time. How long the period of contemplated advantage or the benefit should be in order to constitute benefit of an enduring nature would depend upon the facts and circumstances of each individual case. Although enduring benefit need not be of an everlasting character, it should not be so transitory and ephemeral that it may be terminated at any time at the volition of any of the parties to the contract.

(v) In cases of acquisition of a capital asset, it is immaterial whether the price for it is paid by the assessee once and for all in lumpsum or periodically and also whether it is paid out of capital or income or is linked with the total sales or the turnover of the business. In such a case, the expenditure or outgoing would constitute payment of a capital nature although it may indirectly be linked to or is paid out of revenue profit or sales.

(vi) In cases where the amount paid for acquisition of an asset of an enduring nature is settled, by the mere fact that the amount so settled is chalked out into various small amounts or periodical instalments the capital nature of the transaction or expenditure would not in any way be affected nor the fact that the payment is made in instalments or in small amounts would in any way alter the nature of the expenditure from capital to revenue. In other words, the magnitude of the payment and its periodicity would not be deciding factors for determining the capital or revenue nature of any particular payment.

(vii) A lumpsum amount paid for liquidating recurring claims would generally be of a revenue nature; it would not cease to be a revenue expenditure or get converted into capital expenditure merely because its payment is spread over a number of years. In such a case it is the intention and the object for which the assets are acquired that determine the nature of the expenditure incurred over it, and not the mode and the manner in which the payment is made nor is it in any way related to or determined by the source of such payment.

(viii) If the expenditure in question is recurring and is incurred by the assessee during the ordinary course of the business or manufacture, it would normally constitute a revenue expenditure.

(ix) An asset or advantage of an enduring nature resulting in capital expenditure does not mean that such an asset should last forever; if the capital asset is, by its very nature, a short lived one, the expenditure incurred over it does not on that account cease to be a capital expenditure.

(x) It is nowhere stipulated in the law that if a benefit of enduring nature is obtained, the expenditure for securing it must be treated as a capital expenditure. If the advantage or the benefit acquired by the assessee is to get stock-in-trade of a business it would constitute a revenue; but if what is acquired by the assessee is not the advantage of getting his current or trading assets directly but of something which requires to be processed before it is converted into stock-in-trade, the expenditure incurred over it would constitute a capital expenditure.

(xi) Further, an item of disbursement may be regarded as capital expenditure when it is referable to fixed capital or a capital asset; it is a revenue expenditure when it is referable to circulating capital or stock in trade. Expenditure which relates to the framework of the taxpayer's business is a capital expenditure. Expenditure incurred for the termination of trading relationship in order to avoid losses occurring in future though

that relationship, whether pecuniary loss or commercial inconvenience, is a revenue expenditure. Expenditure incurred for the initial starting of the business before its setting up for substantial expansion and also expenditure incurred after the discontinuance of the business would be of a capital nature.

The capital or revenue character of a particular item must be decided from the facts and circumstances of each case and must be based upon the principles of law applicable to those facts. The fact that a particular transaction is treated by the parties as capital or revenue in nature or is called a sale, instead of being an agreement to use or let out the particular asset would not convert the capital or revenue character of the transaction. Similarly, the entries made by the parties concerned in their books of account or other documents would not always be indicative or conclusive, as to what the real nature of the transaction is based upon the above principles, the capital or revenue character of a particular expenditure will have to be decided in every case.

Instances of revenue expenditure: Payment made for the use of goodwill, use of quota rights or in the case of a hotel or restaurant business the cost of table linen, crockery, pots is of a revenue expenditure. The cost of dredging carried on by a harbour authority for the purpose of keeping the channels clear for shipping is also of revenue expenditure. Expenditure incurred by a surgeon or businessman on a study tour abroad to acquire knowledge of the latest techniques would be on revenue account.

Circular No.6/2007 dated 11.10.2007 clarifies the issue of allowability of the claim of harvesting and transportation expenses incurred by the Co-operative sugar mills for procuring sugarcane from farmers, who are members of such Co-operative Sugar Mills and who are bound under an agreement to supply the sugarcane exclusively to the concerned sugar Mill.

The issue of allowability of such expenses in the case of Co-operative Sugar Mills has been examined by the CBDT. These expenses are incurred by the Sugar Mills for ensuring an adequate and sustained supply of freshly cut sugarcane that is an essential input for the continuous running of such Mills. These expenses are, therefore, incurred for commercial expediency and are prima facie wholly and exclusively for the purpose of business. Such expenses are, therefore, allowable in the computation of the income of the Co-operative Sugar Mills.

Instances of capital expenditure: Expenditure on improvement to property as distinguished from mere repairs or that which is incurred by a company in raising loans or issuing debentures for capital outlay would be capital expenditure if they are incurred before the business is set up. Legal expenses incurred in connection with the mortgages of the premises belonging to the assessee in which the assessee carries on his business are also capital expenditure.

(5) Advertisements in souvenirs of political parties: Section 37(2B) disallows any deduction on account of advertisement expenses representing contributions made by any

person carrying on business or profession in computing the profits and gains of the business or profession. It has specifically been provided that this provision for disallowance would apply notwithstanding anything to the contrary contained in section 37(1). In other words, the expenditure representing contribution for political purposes would become disallowable even in those cases where the expenditure is otherwise incurred by the assessee in his character as a trader and the amount is wholly and exclusively incurred for the purpose of the business. Accordingly, a taxpayer would not be entitled to any deduction in respect of expenses incurred by him on advertisement in any souvenir, brochure, tract or the like published by any political party, whether it is registered with the Election Commission of India or not.

(6) Explanation to section 37(1) - This Explanation provides that any expenditure incurred by the assessee for any purpose which is an offence or is prohibited by law shall not be allowed as a deduction or allowance.

6.6 INADMISSIBLE DEDUCTIONS [SECTION 40]

By dividing the assessees into distinct groups, this section places absolute restraint on the deductibility of certain expenses as follows :

(i) Section 40(a) - In the case of any assessee, the following expenses are not deductible:

(1) Any interest (not being interest on loan issued for public subscription before the 1st day of April, 1938), royalty, fees for technical services or other sum chargeable under this Act, which is payable, -

(a) outside India;

(b) in India to a non-resident, not being a company or to a foreign company,

on which tax is deductible at source under Chapter XVIIB and such tax has not been deducted or, after deduction, has not been paid during the previous year, or in the subsequent year before the expiry of the time prescribed under section 200(1). It is also provided that where in respect of any such sum, where tax has been deducted in any subsequent year, or has been deducted in the previous year but paid in any subsequent year after the expiry of the time prescribed under section 200(1), such sum shall be allowed as a deduction in computing the income of the previous year in which such tax has been paid.

(2) Section 40(a)(ia) provides that interest, commission, brokerage, rent, royalty, fees for technical/professional services payable to a resident or amounts payable (for carrying out any work contract) to a resident contractor/sub-contractor, on which tax is deductible at source, shall be disallowed if –

(i) such tax has not been deducted; or

(ii) such tax, after deduction, has not been paid –

(a) on or before the due date specified in section 139(1), in a case where the tax was deductible and was so deducted during the last month (i.e., March) of the previous year;

(b) on or before the last day of the previous year, in any other case.

In case the tax is deducted in any subsequent year or has been deducted

(a) during the last month (i.e., March) of the previous year but paid after the due date specified in section 139(1); or

(b) during any other month (i.e., April to February) of the previous year but paid after the end of the previous year,

such sum shall be allowed as deduction in computing the income of the previous year in which such tax has been paid.

If, for instance, tax on royalty paid to Mr. A, a resident, has been deducted during the period between April, 2009 to February, 2010, the same has to be paid by 31st March, 2010. If the deduction has been made in March 2010, the same has to be paid by 31st July/30th September 2010, as the case may be. Otherwise, the expenditure would be disallowed in computing the income for A.Y.2010-11.

If such tax deducted between April 2009 and February 2010 is paid after 31st March 2010, the same would be allowed as deduction in the year of payment. If the tax deducted in March 2010 has been paid after 31st July/ 30th September, 2010, the same would be allowed as deduction in the year of payment.

(3) any sum paid on account of tax or cess levied on profits on the basis of or in proportion to the profits and gains of any business or profession;

(a) Any sum paid outside India (on account of any rate or tax levied) which is eligible for tax relief under section 90 or deduction from the income-tax payable under section 91 is not allowable and is deemed to have never been allowable as a deduction under section 40(a).

(b) However, the tax payers will continue to be eligible for tax credit in respect of income-tax paid in a foreign country in accordance with the provisions of section 90 or section 91, as the case may be.

(c) Any sum paid outside India (on account of any rate or tax levied) and eligible for relief under section 90A will not be allowed as a deduction.

(4) any sum paid on account of wealth tax.

For the purpose of this disallowance the expression 'wealth-tax' means the wealth-tax chargeable under Wealth-tax Act, 1957, or any tax of similar nature or character chargeable under any law in any country outside India or any tax chargeable under such

law with reference to the value of the assets of, or the capital employed in a business or profession carried on by the assessee, whether or not the debts of business or profession are allowed as a deduction in computing the amount with reference to which such tax is charged, but does not include any tax chargeable with reference to the value of any particular asset of the business or profession.

(5) any sum which is chargeable under the head 'Salaries' if it is payable outside India or to a non-resident and if the tax has not been paid thereon nor deducted therefrom under Chapter XVII-B.

(6) any contribution to a provident fund or the fund established for the benefit of employees of the assessee, unless the assessee has made effective arrangements to make sure that tax shall be deducted at source from any payments made from the fund which are chargeable to tax under the head 'Salaries'.

(7) Tax paid on perquisites on behalf of employees is not deductible- In case of an employee, deriving income in the nature of perquisites (other than monetary payments), the amount of tax on such income paid by his employer is exempt from tax in the hands of that employee. Correspondingly, such payment is not allowed as deduction from the income of the employer. Thus, the payment of tax on perquisites by an employer on behalf of employee will be exempt from tax in the hands of employee but will not be allowable as deduction in the hands of the employer.

(ii) Section 40(b) - In the case of any firm assessable as such *or a limited liability partnership(LLP)* the following amounts shall not be deducted in computing the income from business of any firm/*LLP* :

(1) Any salary, bonus, commission, remuneration by whatever name called, to any partner who is not a working partner. (In the following discussion, the term 'remuneration' is applied to denote payments in the nature of salary, bonus, commission);

(2) Any remuneration paid to the working partner or interest to any partner which is not authorised by or which is inconsistent with the terms of the partnership deed;

(3) It is possible that the current partnership deed may authorise payments of remuneration to any working partner or interest to any partner for a period which is prior to the date of the current partnership deed. The approval by the current partnership deed might have been necessitated due to the fact that such payment was not authorised by or was inconsistent with the earlier partnership deed. Such payments of remuneration or interest will also be disallowed. However, it should be noted that the current partnership deed cannot authorise any payment which relates to a period prior to the date of earlier partnership deed.

Next, by virtue of a further restriction contained in sub-clause (iii) of section 40(b), such remuneration paid to the working partners will be allowed as deduction to the firm from the date of such partnership deed and not for any period prior thereto. Consequently, if,

for instance, a firm incorporates the clause relating to payment of remuneration to the working partners, by executing an appropriate deed, say, on July 1, but effective from April 1, the firm would get deduction for the remuneration paid to its working partners from July 1 and onwards, but not for the period from April 1 to June 30. In other words, it will not be possible to give retrospective effect to oral agreements entered into vis a vis such remuneration prior to putting the same in a written partnership deed.

(4) Any interest payment authorised by the partnership deed falling after the date of such deed to the extent such interest exceeds 12% simple interest p.a.

(5) Any remuneration paid to a partner, authorised by a partnership deed and falling after the date of the deed in excess of the following limits:

On the first Rs.3 lakh of book profit or in case of loss, the limit would be the higher of Rs.1,50,000 or 90% of book profit and on the balance of book profit, the limit would be 60%.

Example

If a firm has paid Rs.7,50,000 as remuneration to its partners for the P.Y.2009-10 in accordance with its partnership deed, and it has a book profit of Rs.10 lakh, then, the allowable remuneration calculated as per the limits specified in section 40(b)(v) would be -

Particulars	***Rs.***
On first Rs.3 lakh of book profit [3,00,000 × 90%]	*2,70,000*
On balance Rs.7 lakh of book profit [7,00,000 × 60%]	*4,20,000*
	6,90,000

The excess amount of Rs.60,000 (i.e., Rs.7,50,000 – Rs.6,90,000) would be disallowed as per section 40(b)(v).

There are four Explanations to section 40(b):

Explanation 1 provides that where an individual is a partner in a firm in a representative capacity:

(i) interest paid by the firm to such individual otherwise than as partner in a representative capacity shall not be taken into account for the purposes of this clause.

(ii) interest paid by the firm to such individual as partner in a representative capacity and interest paid by the firm to the person so represented shall be taken into account for the purposes of this clause.

Explanation 2 provides that where an individual is a partner in a firm otherwise than in a representative capacity, interest paid to him by the firm shall not be taken into account if he receives the same on behalf of or for the benefit of any other person.

6.68 Income Tax

Explanation 3 defines the term “book profit”. It means the net profit as shown in the P & L A/c for the relevant previous year computed in accordance with the provisions for computing income from profits and gains.

The above amount should be increased by the remuneration paid or payable to all the partners of the firm if the same has been deducted while computing the net profit.

Explanation 4 defines a working partner: Accordingly, it 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.

(iii) Section 40(ba) - **Association of persons or body of individuals** : Any payment of interest, salary, commission, bonus or remuneration made by an association of persons or body of individuals to its members will also not be allowed as a deduction in computing the income of the association or body.

There are three Explanations to section 40(ba):

Explanation 1 - Where interest is paid by an AOP or BOI to a member who has paid interest to the AOP/BOI, the amount of interest to be disallowed under clause (ba) shall be limited to the net amount of interest paid by AOP/BOI to the partner.

Explanation 2 - Where an individual is a member in an AOP/BOI on behalf of another person, interest paid by AOP/BOI shall not be taken into account for the purposes of clause (ba). But, interest paid to or received from each person in his representative capacity shall be taken into account.

Explanation 3 - Where an individual is a member in his individual capacity, interest paid to him in his representative capacity shall not be taken into account.

6.7 EXPENSES OR PAYMENTS NOT DEDUCTIBLE IN CERTAIN CIRCUMSTANCES [SECTION 40A]

(i) Payments to relatives and associates - Sub-section (2) of section 40A provides that where the assessee incurs any expenditure in respect of which a payment has been or is to be made to a relative or to an associate concern so much of the expenditure as is considered to be excessive or unreasonable shall be disallowed by the Assessing Officer. While doing so he shall have due regard to :

(i) the market value of the goods, service of facilities for which the payment is made; or

(ii) the legitimate needs of the business or profession carried on by the assessee; or

(iii) the benefit derived by or accruing to the assessee from such a payment.

The word “relative” as defined in the section 2(41) of the Act, means, in relation to individual, the spouse, brother or sister of any lineal ascendant or descendant of that individual. Whether the

assessee is a firm, H.U.F. or an association of persons the relationship will have to be reckoned for the purpose, with reference to the partners of the firm and the members of the family or association. Similarly, where the assessee is a company the relationship will have to be reckoned with reference to the directors or persons having substantial interest in the company. A person shall be deemed to have a substantial interest in a business or profession if -

- in a case where the business or profession is carried on by a company, such person is, at any time during the previous year, the beneficial owner of equity shares carrying not less than 20% of the voting power and
- in any other case such person is, at any time during the previous year, beneficially entitled to not less than 20% the profits of such business or profession.

(ii) Cash payments in excess of Rs.20,000 - According to section 40A(3), where the assessee incurs any expenditure, in respect of which payment or aggregate of payments made to a person in a day otherwise than by an account payee cheque drawn on a bank or by an account payee bank draft exceeds Rs.20,000, such expenditure shall not be allowed as a deduction.

For example if, in respect of an expenditure of Rs.60,000 incurred by X Ltd., 4 cash payments of Rs.15,000 are made on a particular day to one Mr.Y – one in the morning at 10 a.m., one at 12 noon, one at 3 p.m. and one at 6 p.m., the entire expenditure of Rs.60,000 would be disallowed under section 40A(3), since the aggregate of cash payments made during a day to Mr.Y exceeds Rs.20,000.

In case of an assessee following mercantile system of accounting, if an expenditure has been allowed as deduction in any previous year on due basis, and payment has been made in a subsequent year otherwise than by account payee cheque or account payee bank draft, then the payment so made shall be deemed to be the income of the subsequent year if such payment or aggregate of payments made to a person in a day exceeds Rs.20,000 [Section 40A(3A)].

This limit of Rs.20,000 has been raised to Rs.35,000 with effect from 1st October, 2009 in case of payment made to transport operators for plying, hiring or leasing goods carriages. Therefore, payment or aggregate of payments up to Rs.35,000 in a day can be made to a transport operator otherwise than by way of account payee cheque or account payee bank draft. In all other cases, the limit would continue to be Rs.20,000.

However, no disallowance would be made in such cases and under such circumstances as may be prescribed, having regard to the nature and extent of banking facilities available, considerations of business expediency and other relevant factors.

The provision applies to all categories of expenditure involving payments for goods or services which are deductible in computing the taxable income. It does not apply to loan transactions because advancing of loans or repayments of the principal amount of loan

does not constitute an expenditure deductible in computing the taxable income. However, interest payments of amounts exceeding Rs.20,000 at a time are required to be made by account payee cheques or drafts as interest is a deductible expenditure. This requirement does not apply to payment made by commission agents for goods received by them for sale on commission or consignment basis because such a payment is not an expenditure deductible in computing the taxable income of the commission agent. For the same reason, this requirement does not apply to advance payment made by the commission agent to the party concerned against supply of goods. However, where commission agent purchases goods on his own account but not on commission basis, the requirement will apply. The provisions regarding payments by account payee cheque or draft apply equally to payments made for goods purchased on credit.

Rule 6DD provides for cases and circumstances in which a payment or aggregate of payments exceeding twenty thousand rupees may be made to a person in a day, otherwise than by an account payee cheque drawn on a bank or account payee bank draft. As per this rule, no disallowance under sub-section (3) of section 40A shall be made and no payment shall be deemed to be the profits and gains of business or profession under sub-section (3A) of section 40A where a payment or aggregate of payments made to a person in a day, otherwise than by an account payee cheque drawn on a bank or account payee bank draft, exceeds twenty thousand rupees in the cases and circumstances specified hereunder, namely:

(a) where the payment is made to

- *(i) the Reserve Bank of India or any banking company;*
- *(ii) the State Bank of India or any subsidiary bank;*
- *(iii) any co-operative bank or land mortgage bank;*
- *(iv) any primary agricultural credit society or any primary credit society;*
- *(v) the Life Insurance Corporation of India;*

(b) where the payment is made to the Government and, under the rules framed by it, such payment is required to be made in legal tender;

(c) where the payment is made by

- *(i) any letter of credit arrangements through a bank;*
- *(ii) a mail or telegraphic transfer through a bank;*
- *(iii) a book adjustment from any account in a bank to any other account in that or any other bank;*
- *(iv) a bill of exchange made payable only to a bank;*
- *(v) the use of electronic clearing system through a bank account;*

(vi) *a credit card;*

(vii) *a debit card.*

(d) *where the payment is made by way of adjustment against the amount of any liability incurred by the payee for any goods supplied or services rendered by the assessee to such payee;*

(e) *where the payment is made for the purchase of -*

(i) *agricultural or forest produce; or*

(ii) *the produce of animal husbandry (including livestock, meat, hides and skins) or dairy or poultry farming; or*

(iii) *fish or fish products; or*

(iv) *the products of horticulture or apiculture,*

to the cultivator, grower or producer of such articles, produce or products;

Note -

(i) *The expression 'fish or fish products' (iii) above would include 'other marine products such as shrimp, prawn, cuttlefish, squid, crab, lobster etc.'.*

(ii) *The 'producers' of fish or fish products for the purpose of rule 6DD(e) would include, besides the fishermen, any headman of fishermen, who sorts the catch of fish brought by fishermen from the sea, at the sea shore itself and then sells the fish or fish products to traders, exporters etc.*

However, the above exception will not be available on the payment for the purchase of fish or fish products from a person who is not proved to be a 'producer' of these goods and is only a trader, broker or any other middleman, by whatever name called.

(f) *where the payment is made for the purchase of the products manufactured or processed without the aid of power in a cottage industry, to the producer of such products;*

(g) *where the payment is made in a village or town, which on the date of such payment is not served by any bank, to any person who ordinarily resides, or is carrying on any business, profession or vocation, in any such village or town;*

(h) *where any payment is made to an employee of the assessee or the heir of any such employee, on or in connection with the retirement, retrenchment, resignation, discharge or death of such employee, on account of gratuity, retrenchment compensation or similar terminal benefit and the aggregate of such sums payable to the employee or his heir does not exceed fifty thousand rupees;*

(i) *where the payment is made by an assessee by way of salary to his employee after*

deducting the income-tax from salary in accordance with the provisions of section 192 of the Act, and when such employee -

(i) is temporarily posted for a continuous period of fifteen days or more in a place other than his normal place of duty or on a ship; and

(ii) does not maintain any account in any bank at such place or ship;

(j) where the payment was required to be made on a day on which the banks were closed either on account of holiday or strike;

(k) where the payment is made by any person to his agent who is required to make payment in cash for goods or services on behalf of such person;

(l) where the payment is made by an authorised dealer or a money changer against purchase of foreign currency or travellers cheques in the normal course of his business.

(iii) Disallowance of provision for gratuity - Section 40A(7) provides that no deduction would be allowable to any taxpayer carrying on any business or profession in respect of any provision (whether called as provision or by any other names) made by him towards the payment of gratuity to his employers on their retirement or on the termination of their employment for any reason. The reason for this disallowance is that, under section 36(1)(v), deduction is allowable in computing the profits and gains of the business or profession in respect of any sum paid by a taxpayer in his capacity as an employer in the form of contributions made by him to an approved gratuity fund created for the exclusive benefit of his employees under an irrevocable trust. Further, section 37(1) provides that any expenditure other than the expenditure of the nature described in sections 30 to 36 laid out or expended, wholly and exclusively for the purpose of the business or profession must be allowed as a deduction in computing the taxable income from business. A reading of these two provisions clearly indicates that the intention of the legislature has always been that the deduction in respect of gratuity be allowable to the employer either in the year in which the gratuity is actually paid or in the year in which contributions to an approved gratuity fund are actually made by employer. This provision, therefore, makes it clear that any amount claimed by the assessee towards provision for gratuity, by whatever name called would be disallowable in the assessment of employer even if the assessee follows the mercantile system of accounting.

However, no disallowance would be made under the provision of sub-section (7) of section 40A in the case where any provision is made by the employer for the purpose of payment of sum by way of contribution to an approved gratuity fund during the previous year or for the purpose of making payment of any gratuity that has become payable during the previous year by virtue of the employee's retirement, death, termination of service etc.

(iv) Contributions by employers to funds, trust etc. [Sections 40A(9) to (11)] - These sub-sections have been introduced to curb the growing practice amongst employers to claim deductions from taxable profits of the business of contributions made apparently to the welfare of employees from which, however, no genuine benefit flows to the employees.

Accordingly, no deduction will be allowed where the assessee pays in his capacity as an employer, any sum towards setting up or formation of or as contribution to any fund, trust, company, association of persons, body of individuals, society registered under the Societies Registration Act, 1860 or other institution for any purpose. However, where such sum is paid in respect of funds covered by sections 36(1)(iv) and 36(1)(v) or any other law, then the deduction will not be denied.

(v) Deduction in respect of Head Office expenses, in the case of non-residents - Section 44C restricts the scope of deduction available to non-resident taxpayers in the matter of allowance of head office expenses in computing their taxable income from the business carried on in India. These restrictions would have the effect of overriding anything to the contrary contained in the provisions for allowance of expenses and other deductions contained in sections 28 to 43A of the Income-tax Act. This provision prescribes the limits upto which the deduction could be allowed in computing profits and gains from any business carried on by the non-resident in India and apply to the expenses in the matter of head office expenses.

For the purpose of those restrictions and the consequent disallowance, the expression 'head office expenditure' must be taken to mean executive and general administration expenses incurred by the assessee outside India including also the expenditure incurred in respect of the following items viz.,

(i) rent, rates, taxes, repairs or insurance in respect of any premises outside India used for the purpose of the business or profession;

(ii) salary, wages, annuity, pension, fees, bonus, commission, gratuity, perquisites or profit in lieu of or in addition to salary, whether paid or allowed to any employee or other persons employed in, or managing the affairs of any office in India;

(iii) travelling expenses incurred in respect of any employee or other person who is employed in or who is looking after the management of the affairs of any office outside India; and

(iv) such other matter connected with executive and general administration of the business as may be prescribed by the Central Board of Direct Taxes from time to time.

The limits prescribed are the following :

(i) an amount equal to 5% of the adjusted total income of the assessee; or

(ii) an amount of so much of the expenditure in the nature of head office expenses (explained above), which are incurred by the assessee, as is attributable to the business

or profession of the assessee in India.

The limit upto which the deduction is permissible to the assessee is the lesser of the aforesaid two amounts and consequently, the basis for allowance would be the lower of the above two items. If, however the actual amount on account of head office expenses claimed by the assessee is less than the limits specified above, the deduction admissible would be confined to the amount of actual expenditure incurred by the assessee.

For the purpose of determining the amount of deduction admissible to the assessee, the expression 'adjusted total income' used in item (i) above must be taken to mean the total income of the assessee computed in accordance with the provisions of the Income-tax Act before giving effect to the following items of allowance on deduction viz.,—

(a) depreciation allowance under section 32(2);

(b) capital expenditure on family planning incurred by companies admissible as a deduction under section 36(ix);

(c) any brought-forward business loss qualifying for set off against business income in accordance with the provisions of section 72(1);

(d) any brought-forward loss in regard to any speculation business qualifying for set off against income from speculation under section 73(3);

(e) any loss computed under the head 'capital gains' and brought forward from earlier assessment year qualifying for set-off under section 74(1), and

(f) any loss attributable to the casual item of income assessable under section 56 qualifying for set-off in accordance with the provisions of section 74A(3).

Thus the total income of the assessee computed for the relevant accounting year must be first ascertained before giving effect to the provisions for the aforesaid allowance and 5% thereof would be treated as the limit upto which head office expenses would be admissible as a deduction in computing the business income of the non-resident for income-tax purposes.

However, in cases where the adjusted total income of the assessee, 5% of which is to be taken as the basis for determining the first of the qualifying limits, happens to be a loss, the proviso to section 44C authorises the limit of 5% to be taken with reference to the average adjusted total income. For this purpose the expression 'average adjusted total income' would mean —

(i) in cases where the total income of the assessee is assessable for each of the three assessment years immediately preceding the relevant assessment year - one-third of the aggregate amount of the adjusted total income of the previous years relevant to the aforesaid three assessment years.

(ii) where the total income of the assessee is assessable for only two of the aforesaid three assessment years - one-half of the aggregate amount of the adjusted total income in

respect of the two previous years relevant to the aforesaid two assessment years;

(iii) in cases where the total income of the assessee becomes assessable only for one of the three assessment years aforesaid - the amount of adjusted total incomes in respect of the previous year relevant to the assessment year.

The aforesaid provisions of restricting allowances on account of deduction in respect of head office expenditure would apply in the case of all non-resident taxpayers whose income from business or profession is chargeable to income-tax under section 28 of the Income-tax Act. The provisions for disallowance of the excess of the expenditure over the least of the limits mentioned above would apply even if the expenditure is such that it does not attract the provisions for disallowance contained in any other section of the Income-tax Act.

6.8 PROFITS CHARGEABLE TO TAX [SECTION 41]

This section enumerates certain receipts which are deemed to be income under the head "Business or profession." Such receipts would attract charge even if the business from which they arise had ceased to exist prior to the year in which the liability under this section arises. The particulars of such receipts are given below:

(i) Section 41(1) - Suppose an allowance or deduction has been made in any assessment year in respect of loss, expenditure or trading liability incurred by A. Subsequently, if A has obtained, whether in cash or in any manner whatsoever, any amount in respect of such loss or expenditure of some benefit in respect of such trading liability by way of remission or cessation thereof, the amount obtained by A, or the value of benefit accruing to him shall be taxed as income of that previous year. It does not matter whether the business or profession in respect of which the allowance or deduction has been made is in existence in that year or not.

It is possible that after the above allowance in respect of loss, expenditure, or trading liability has been given to A, he could have been succeeded in his business by another person. In such a case, the successor will be liable to be taxed in respect of any such benefit received by him during a subsequent previous year.

Successor in business:

(i) Where there has been an amalgamation of a company with another company, the successor will be the amalgamated company.

(ii) Where a firm carrying on a business or profession is succeeded by another firm the successor will be the other firm.

(iii) In any other case, where one person is succeeded by any other person in that business or profession the other person will be the successor.

(iv) In case of a demerger, the successor will be the resulting company.

Remission or cessation of a trading liability includes remission or cessation of liability by a unilateral act of the assessee by way of writing off such liability in his accounts.

(ii) Balancing charge, etc. - The provisions of section 41(2) relating to balancing charge, of section 41(3) relating to assets acquired for scientific research and of section 41(4) dealing with recovery of bad debts have been dealt with earlier under the respective items.

(iii) Section 41(4A) - The withdrawal from special reserve created and maintained under section 36(1)(viii) will be deemed to be profits and gains of business and charged accordingly in the year of withdrawal. Even if the business is closed, it will be deemed to be in existence for this purpose. This also applies to section 41(5).

Brought forward losses of defunct business - In cases where a receipt is deemed under this section to be profit of a business under this section relating to a business that had ceased to exist and there is an unabsorbed loss, which arose in that business during the previous year in which it had ceased to exist, it would be set off against income that is chargeable under this section. This sub-section thus constitutes an exception to the rule that if a business has ceased to exist, any loss relating to it cannot be carried forward and set off against any income from any source.

6.9 SPECIAL PROVISIONS FOR DEDUCTION IN CASE OF BUSINESS FOR PROSPECTING ETC. FOR MINERAL OIL [SECTION 42]

This section has been enacted to permit an assessee to claim an allowance which may on general principles be inadmissible, e.g., allowance in respect of expenditure which would be regarded as an accretion to capital on the ground that it brings into existence an asset of enduring benefit or to constitute initial expenditure incurred on the setting up of a profit-earning machinery in motion. It must further be noted that this concession can be availed of only in relation to contract or arrangements entered into by the Central Government for prospecting for, or the extraction or production of mineral oils.

Allowable expenses : The allowance permissible under this section shall be in relation to (i) the expenditure by way of in fructuous or abortive exploration expenses in respect of an area surrendered prior to the beginning of commercial production by the assessee; (ii) after the beginning of commercial production, the expenditure incurred by the assessee, whether before or after such commercial production in respect of drilling or exploration activities in services in respect of physical assets used in that connection (except those assets which qualify for depreciation allowance under section 32); and (iii) to the depletion of mineral oil in the mining area in respect of the assessment year relevant to the previous year in which commercial production is begun and for such succeeding years as may be specified in the agreement.

Amount of deduction: The sum of those allowance should be computed and deduction should be made in the manner specified in the agreement entered into by the Central Government with any person for the association or participation in the business of the Central Government for the prospecting or exploration of mineral oil. It has been specifically provided that the other provisions of the Act are being deemed, for the purpose of this allowance, to

have been modified to the extent necessary to give effect to the terms of the agreement. It may be noted that allowances in this regard are made in lieu of or in addition to the other allowances permissible under the Act, depending upon the terms of the agreement.

Subject to the provisions of the agreement entered into by the Central Government, where the business of assessee consisting of the prospecting for or extraction or production of petroleum and natural gas is transferred or any interest therein is transferred, wholly or partly, in accordance with the aforesaid agreement, various situations would arise. The tax treatment in respect of those situations are as follows:

(1) Where the proceeds of the transfer so far as they consist of capital sums are less than the expenditure incurred remaining unallowed, a deduction equal to such expenditure remaining unallowed, as reduced by the proceeds of transfer, shall be allowed in respect of the previous year in which such business or interest is transferred.

(2) Where such proceeds exceed the amount of the expenditure incurred remaining unallowed, so much of the excess as does not exceed the difference between the expenditure incurred in connection with the business or to obtain interest therein and the amount of such expenditure remaining unallowed, shall be chargeable to income-tax as profits and gains of the business in the previous year in which the business or interest therein, whether wholly or partly, had been transferred.

However, in a case where the provisions of this clause do not apply, the deduction to be allowed for expenditure incurred remaining unallowed shall be arrived at by subtracting the proceeds of transfer (so far as they consist of capital sums) from the expenditure remaining unallowed.

Explanation - Where the business or interest in such business is transferred in a previous year in which such business carried on by the assessee is no longer in existence, the provisions of this clause shall apply as if the business is in existence in that previous year.

(3) Where such proceeds are not less than the amount of the expenditure incurred remaining unallowed, no deduction for such expenditure shall be allowed in respect of the previous year in which the business or interest in such business is transferred or in respect of any subsequent year or years.

Special provisions in case of amalgamation/demerger

Where in a scheme of amalgamation, the amalgamating company sells or otherwise transfers the business to the amalgamated company (being an Indian company), the provisions of this sub-section—

(i) shall not apply in the case of the amalgamating company and

(ii) shall, as far as may be, apply to the amalgamated company as they would have applied to the amalgamated company if the latter had not transferred the business or interest in the business.

The section provides for similar provisions in the case of demerger where the resulting company, being an Indian company, shall claim the production under the said section.

6.10 CHANGES IN THE RATE OF EXCHANGE OF CURRENCY [SECTION 43A]

The section provides that where an assessee has acquired any asset from a foreign country for the purpose of his business or profession, and due to a change thereafter in the exchange rate of the two currencies involved, there is an increase or decrease in the liability (expressed in Indian rupees) of the assessee at the time of making the payment, the following values may be changed accordingly with respect to the increase or decrease in such liability:

(i) the actual cost of the asset under section 43(1)

(ii) the amount of capital expenditure incurred on scientific research under section 35(1)(iv)

(iii) the amount of capital expenditure on acquisition of patents or copyrights under section 35A

(iv) the amount of capital expenditure incurred by a company for promoting family planning amongst its employees under section 36(1)(ix)

(v) the cost of acquisition of a non-depreciable capital asset falling under section 48.

The amount arrived at after making the above adjustment shall be taken as the amount of capital expenditure or the cost of acquisition of the capital asset, as the case may be.

The section further clarifies that where any adjustment has already been made under the erstwhile section 43A to the amount of capital expenditure or cost of acquisition of an asset on account of increase or decrease in liability due to exchange rate fluctuation, it should be verified that the amount of such adjustment is equal to the change in the liability at the time of making payment.

In this context

(a) “rate of exchange” means the rate of exchange determined or recognised by the Central Government for the conversion of Indian currency into foreign currency or foreign currency into Indian currency;

(b) “foreign currency” and “Indian currency” have the meanings respectively assigned to them in section 2 of the Foreign Exchange Management Act, 1999.

Where the whole or any part of the liability aforesaid is met, not by the assessee, but, directly or indirectly, by any other person or authority, the liability so met shall not be taken into account for the purposes of this section.

Where the assessee has entered into a contract with a authorised dealer as defined in section 2 of the Foreign Exchange Management Act, 1999 for providing him with a specified sum in a foreign currency on or after a stipulated future date at the rate of exchange specified in the

contract to enable him to meet the whole or any part of the liability aforesaid, the amount, if any, for adjustment under this section shall be computed with reference to the rate of exchange specified therein.

6.11 CERTAIN DEDUCTIONS TO BE ONLY ON ACTUAL PAYMENT [SECTION 43B]

The following sums are allowed as deduction only on the basis of actual payment within the time limits specified in section 43B.

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

(b) Any sum payable by 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.

(c) Bonus or Commission for services rendered payable to employees.

(d) Any sum payable by the assessee as interest on any loan or borrowing from any public financial institution or a State Financial Corporation or a State Industrial Investment Corporation.

(e) Interest on any loan or advance from a scheduled bank on actual payment basis.

(f) Any sum paid by the assessee as an employer in lieu of earned leave of his employee.

The above sums can be paid by the assessee on or before the due date for furnishing the return of income under section 139(1) in respect of the previous year in which the liability to pay such sum was incurred and the evidence of such payment is furnished by the assessee along with such return.

For the purposes of clause (a), “any sum payable” means a sum for which the assessee incurred liability in the previous year even though such sum might not have been payable within that year under the relevant law. For example, an assessee may collect sales tax from customers during the month of March, 2008. However, in respect of such collections he may have to discharge the liability only within say 10th of April, 2008 under Sales Tax law. The explanation covers this type of liability also. Consequently, if an assessee following accrual method of accounting has created a provision in respect of such a liability the same is not deductible unless remitted within the due date specified in this section.

For this purpose, scheduled bank has the meaning assigned to it in clause (iii) of the Explanation to section 11(5), that is, the State Bank of India (SBI), a subsidiary of SBI, a nationalised bank or any other bank included in the Second Schedule to the Reserve Bank of India Act, 1934.

"State Industrial Investment Corporation" means a Government company within the

meaning of section 617 of the Companies Act, 1956, engaged in providing long-term finance for industrial projects and eligible for deduction under section 36(1)(iii).

Explanation 3B provides that where a deduction in respect of earned leave encashment paid to any employee is allowed in computing the business income of the employer for the previous year in which the liability to pay was incurred (applicable for previous year 2000-2001 or any earlier year), no deduction shall be allowed in respect of such sum in the previous year in which the sum is actually paid.

Explanation 3C & 3D clarifies that if any sum payable by the assessee as interest on any such loan or borrowing or advance referred to in (d) and (e) above, is converted into a loan or borrowing or advance, the interest so converted and not "actually paid" shall not be deemed as actual payment, and hence would not be allowed as deduction. The clarificatory explanations only reiterate the rationale that conversion of interest into a loan or borrowing or advance does not amount to actual payment.

The manner in which the converted interest will be allowed as deduction has been clarified in Circular No.7/2006 dated 17.7.2006. The unpaid interest, whenever actually paid to the bank or financial institution, will be in the nature of revenue expenditure deserving deduction in the computation of income. Therefore, irrespective of the nomenclature, the deduction will be allowed in the previous year in which the converted interest is actually paid.

Illustration 3

Hari, an individual, carried on the business of purchase and sale of agricultural commodities like paddy, wheat, etc. He borrowed loans from Andhra Pradesh State Financial Corporation and Indian Bank and has not paid interest as detailed hereunder:

(i)	Andhra Pradesh State Financial Corporation (P.Y. 2008-09 & 2009-10)	15,00,000
(ii)	Indian Bank (P.Y. 2009-10)	30,00,000
		45,00,000

Both Andhra Pradesh State Financial Corporation and Indian Bank, while restructuring the loan facilities of Hari during the year 2009-10, converted the above interest payable by Hari to them as a loan repayable in 60 equal installments. During the year ended 31.3.2010, Hari paid 5 installments to Andhra Pradesh State Financial Corporation and 3 installments to Indian Bank.

Hari claimed the entire interest of Rs.45,00,000 as an expenditure while computing the income from business of purchase and sale of agricultural commodities. Discuss whether his claim is valid and if not what is the amount of interest, if any, allowable.

Solution

According to section 43B, any interest payable on the term loans to specified financial institutions and any interest payable on any loans and advances to scheduled banks shall be allowed only in the year of payment of such interest irrespective of the method of accounting followed by the assessee. Where there is default in the payment of interest by the assessee, such unpaid interest may be converted into loan. Such conversion of unpaid interest into loan shall not be construed as payment of interest for the purpose of section 43B. The amount of unpaid interest so converted as loan shall be allowed as deduction only in the year in which the converted loan is actually paid.

In the given case of Hari, the unpaid interest of Rs.15,00,000 due to Andhra Pradesh State Financial Corporation (APSFC) and of Rs.30,00,000 due to Indian Bank was converted into loan. Such conversion would not amount to payment of interest and would not, therefore, be eligible for deduction in the year of such conversion. Hence, claim of Hari that the entire interest of Rs.45,00,000 is to be allowed as deduction in the year of conversion is not tenable. The deduction shall be allowed only to the extent of repayment made during the financial year. Accordingly, the amount of interest eligible for deduction for the A.Y. 2010-11 shall be calculated as follows:

	Interest outstanding	Number of Installments	Amount per installment	Installments paid	Interest allowable (Rs.)
APSFC	15 lakh	60	25,000	5	1,25,000
Indian Bank	30 lakh	60	50,000	3	1,50,000
Total amount eligible for deduction					**2,75,000**

6.12 SPECIAL PROVISION FOR COMPUTATION OF COST OF ACQUISITION OF CERTAIN ASSETS [SECTION 43C]

(i) Where an asset acquired under a scheme of amalgamation is sold by an amalgamated company as its stock-in-trade then in computing the profits and gains derived from sale of such stock-in-trade the cost of acquisition of stock-in-trade to the amalgamated company shall be the cost of acquisition of such stock-in-trade or the asset to the amalgamating company as increased by the cost if any of any improvement thereto and the expenditure incurred wholly and exclusively in connection with such a transfer.

(ii) The provisions of section 43C will thus apply to the following cases of revaluation:

(a) When the stock-in-trade of the amalgamating company is taken over at reduced price by the amalgamated company under the scheme of amalgamation.

(b) Where a capital asset of the amalgamating company is taken over as stock-in-trade by the amalgamated company after revaluation under the scheme of amalgamation.

(iii) The situation referred to at (b) above will in turn cover three situations :

(1) When the capital asset is converted to stock-in-trade by the amalgamating company with revaluation and the revalued asset is taken over by the amalgamated company under the scheme of amalgamation.

(2) Where the capital asset is taken over as stock-in-trade by the amalgamated company at renewed price at the time of amalgamation.

(3) Where the capital asset of the amalgamating company is taken over by the amalgamated company as a capital asset and has been converted into stock-in-trade and revalued.

(iv) In a case referred to above, where the revaluation and conversion of capital asset into stock-in-trade takes place in the hands of the amalgamated company the provisions of section 45(2) will apply. So in such a case the provision of section 43C will not apply. This has been done with a view to ensure that a tax payer does not face double taxation in respect of the same transaction. However when the stock-in-trade referred to in item (i) as well as at (a) and (b) above are sold, the provisions of section 43C will apply.

(v) A similar provision in section 43C has also been made to cover cases where the asset sold as stock-in-trade has been acquired by the assessee either by way of full or partial partition of HUF or under a gift or will or an irrevocable trust and such asset is sold as stock-in-trade.

6.13 SPECIAL PROVISION IN CASE OF INCOME OF PUBLIC FINANCIAL INSTITUTIONS [SECTION 43D]

(i) In the case of a public financial institution or a scheduled bank or a State financial corporation or a State industrial investment corporation, the income by way of interest on such categories of bad and doubtful debts, as may be prescribed having regard to the guidelines issued by the Reserve Bank of India in relation to such debts, shall be chargeable to tax in the previous year in which it is credited to the profit and loss account by the said institutions for that year or in the previous year in which it is actually received by them, whichever is earlier. This provision is now applicable to co-operative banks also [Sub-clause (a)].

(ii) In the case of a public company, the income by way of interest in relation to such categories of bad and doubtful debts as may be prescribed having regard to the guidelines issued by the National Housing Bank established under the National Housing Bank Act, 1987 in relation to such debts shall be chargeable to tax in the previous year in which it is credited to the profit and loss account by the said public company for that year or in the previous in which it is actually received by it, whichever is earlier. [Sub-clause (b)].

6.14 INSURANCE BUSINESS [SECTION 44]

This Section exempts an insurance business of any kind from the operation of the Section dealing with specified heads of income as well as those of section 199 which deals, with

credits for tax deducted at source, to the extent to which the provisions of this section are inconsistent with the Rules contained in the First Schedule to the Act, and provides that the profits and gains of such a business, from all sources, are to be computed notionally in accordance with these rules. The principle is applicable even to mutual associations and co-operative societies carrying on insurance business. For further details please refer to the First Schedule to the Income-tax Act.

6.15 SPECIAL PROVISIONS IN THE CASE OF CERTAIN ASSOCIATIONS [SECTION 44A]

This is a provision calculated to encourage the development activities carried on by the trade, professional and other associations other than those whose incomes are already exempted under section 10(23A). This section provides that where the expenditure incurred by an association solely for purposes of protection or advancement of the common interest of its members exceeds the amount collected by the association from the members whether by way of subscription or otherwise, the resulting deficiency shall be allowed as a deduction in computing the income of the association assessable under the head "profits and gains of business or profession"; if there is no such income, then, it will be allowed as a deduction in computing the income under any other head. But only an amount upto 50% of total taxable income of the association can be set off against the deficiency aforementioned. In computing the taxable income of the association, effect must first be given to the allowances or losses brought forward under any other section of the Act. This section applies only to such associations which do not distribute their income amongst their members except in the form of grants to affiliated associations.

6.16 COMPULSORY MAINTENANCE OF ACCOUNTS [SECTION 44AA]

This section provides that every person carrying on the legal, medical, engineering or architectural profession or accountancy or technical consultancy or interior decoration or any other profession as has been notified by the Central Board of Direct Taxes in the Official Gazette must statutorily maintain such books of accounts and other documents as may enable the Assessing Officer to compute his total income in accordance with the provisions of the Income-tax Act. The persons carrying on these professions are statutorily obliged to maintain the prescribed books of account and other documents regardless of the quantum of their income and also regardless of the question whether the profession was set up prior to or after the coming into force of this new provision.

The professions notified so far are as follows :

The profession of authorised representative; the profession of film artiste (actor, camera man, director, music director, art director, editor, singer, lyricist, story writer, screen play writer, dialogue writer and dress designer); the profession of Company Secretary; and information technology professionals.

6.84 Income Tax

Every taxpayer carrying on any business or profession (other than the professions specified above) must maintain the books of account prescribed by the Central Board of Direct Taxes in the following circumstances:

(a) in cases where the income from the business or profession exceeds Rs.1,20,000 or the total sales turnover or gross receipts, as the case may be, in the business or profession exceed Rs.10,00,000 in any one of three years immediately preceding the accounting year; or

(b) in cases where the business or profession is newly set up in any previous year, if his income from business or profession is likely to exceed Rs.1,20,000 or his total sales turnover or gross receipts, as the case may be, in the business or profession are likely to exceed Rs.10,00,000 during the previous year ;

(c) in cases where profits and gains from the business are calculated on a presumptive basis under section 44AD or 44AE or 44AF or 44BB or 44BBB and the assessee has claimed that his income is lower than the profits or gains so deemed to be the profits and gains of his business.

(d) in cases where the profits and gains from the business are deemed to be the profits and gains of the assessee under section 44AD and he has claimed such income to be lower than the profits and gains so deemed to be the profits and gains of his business and his income exceeds the basic exemption limit during such previous year (This would be effective from A.Y.2011-12)

In such cases, compulsory tax audit would also become necessary.

The Central Board of Direct Taxes has been authorised, having due regard to the nature of the business or profession carried on by any class of persons, to prescribe by rules the books of account and other documents including inventories, wherever necessary, to be kept and maintained by the taxpayer, the particulars to be contained therein and the form and manner in which and the place at which they must be kept and maintained. Further, the Central Board of Direct Taxes has also been empowered to prescribe, by rules, the period for which the books of account and other documents are required to be kept and maintained by the taxpayer.

Rule 6F of the Income-tax Rules contains the details relating to the books of account and other documents to be maintained by certain professionals under section 44A.

As per Rule 6F, every person carrying on legal, medical, engineering, or architectural profession or the profession of accountancy or technical consultancy or interior decoration or authorised representative or film artist shall keep and maintain the books of account and other documents specified in sub-rule (2) in the following cases :

– if his gross receipts exceed Rs.1,50,000 in any one of the 3 years immediately preceding the previous year ; or

– if, where the profession has been newly set up in the previous year, his gross receipts are likely to exceed Rs.1,50,000 in that year.

Note : Students may note that professionals whose gross receipts are less than the specified limits given above are also required to maintain books of account but these have not been specified in the Rule. In other words, they are required to maintain such books of account and other documents as may enable the Assessing Officer to compute the total income in accordance with the provisions of this Act.

Sub-rule (2) of Rule 6F

The following books of account and other documents are required to be maintained.

(i) a cash book;

(ii) a journal, if accounts are maintained on mercantile basis ;

(iii) a ledger;

(iv) Carbon copies of bills and receipts issued by the person whether machine numbered or otherwise serially numbered, in relation to sums exceeding Rs.25;

(v) Original bills and receipts issued to the person in respect of expenditure incurred by the person, or where such bills and receipts are not issued, payment vouchers prepared and signed by the person, provided the amount does not exceed Rs.50. Where the cash book contains adequate particulars, the preparation and signing of payment vouchers is not required.

In case of a person carrying on medical profession, he will be required to maintain the following in addition to the list given above :

(i) a daily case register in Form 3C.

(ii) an inventory under broad heads of the stock of drugs, medicines and other consumable accessories as on the first and last day of the previous year used for his profession.

The above books of account and documents shall be kept and maintained for a minimum of 8 years from the end of the relevant assessment year. However, in case of cash book and ledger, the period will be 16 years.

The books and documents shall be kept and maintained at the place where the person is carrying on the profession, or where there is more than one place, at the principal place of his profession. However, if he maintains separate set of books for each place of his profession, such books and documents may be kept and maintained at the respective places.

6.17 AUDIT OF ACCOUNTS OF CERTAIN PERSONS CARRYING ON BUSINESS OR PROFESSION [SECTION 44AB]

(i) It is obligatory in the following cases for a person carrying on business or profession to get his accounts audited before the “specified date” by a Chartered Accountant:

6.86 Income Tax

(1) if the total sales, turnover or gross receipts in business exceeds Rs.40 lakh in any previous year; or

(2) if the gross receipts in profession exceeds Rs.10 lakh in any previous year; or

(3) where the assessee is covered under section 44AD, 44AE, 44AF, 44BB or 44BBB and claims that the profits and gains from business are lower than the profits and gains computed on a presumptive basis. In such cases, the normal monetary limits for tax audit in respect of business would not apply.

(4) where the assessee is covered under section 44AD, and he claims that the profits and gains from business are lower than the profits and gains computed on a presumptive basis and his income exceeds the basic exemption limit. This provision would be effective from A.Y.2011-12.

(ii) The person mentioned above would have to furnish by the specified date a report of the audit in the prescribed forms. For this purpose, the Board has prescribed under Rule 6G, Forms 3CA/3CB/3CD containing forms of audit report and particulars to be furnished therewith.

(iii) In cases where the accounts of a person are required to be audited by or under any other law before the specified date, it will be sufficient if the person gets his accounts audited under such other law before the specified date and also furnish by the said date the report of audit in the prescribed form in addition to the report of audit required under such other law. Thus, for example, the provision regarding compulsory audit does not imply a second or separate audit of accounts of companies whose accounts are already required to be audited under the Companies Act. The provision only requires that companies should get their accounts audited under the Companies Act before the specified date and in addition to the report required to be given by the auditor under the Companies Act, furnish a report for tax purposes in the form to be prescribed in this behalf by the Central Board of Direct Taxes.

(iv) However, the requirement of audit under section 44AB does not apply to a person who derives income of the nature referred to in sections 44B and 44BBA.

(v) The expression "specified date" in relation to the accounts of the previous year or years relevant to any assessment year means the 30th September of the assessment year.

(vi) It may be noted that under section 271B, penal action can be taken for not getting the accounts audited and for not filing the audit report by the specified date. In cases where the audit report has been filed before furnishing of the return, non furnishing of a copy of the audit report or proof of its filing by the specified date along with the return of income will however be only a defect under section 139(9) which can be rectified.

Note - The Institute has brought out a Guidance Note dealing with the various aspects of tax audit under section 44AB. Students are advised to read the same carefully.

6.18 SPECIAL PROVISIONS FOR COMPUTING PROFITS AND GAINS OF CIVIL CONSTRUCTION ETC. [SECTION 44AD]

(i) This section provides for estimating income of an assessee who is engaged in the business of civil construction or supply or labour for civil construction ;

(ii) The income will be estimated at a sum equal to 8% of the gross receipts paid or payable to the assessee in the previous year on account of such business. However, if the assessee declares a higher amount in his return of income, that will be his income ;

(iii) This claim will apply only to such assessees engaged in the business of civil construction etc. whose gross receipts do not exceed Rs.40 lakh;

(iv) The assessee will be deemed to have been allowed deductions under sections 30 to 38. Accordingly, the written down value of any asset utilised for the purpose of the business of the assessee will be deemed to have been calculated as if the assessee had claimed and had actually been allowed the deduction in respect of depreciation for each of the relevant assessment years.

The assessee joining this scheme will not be required to maintain the books of account under section 44AA and section 44AB.

(v) An assessee may claim lower profits and gains than the deemed profits and gains specified in sub-sections (1) and (2) of the section subject to the condition that the books of account and other documents are kept and maintained as required under sub-section (2) of section 44AA and the assessee gets his accounts audited and furnishes a report of such audit as required under section 44AB.

Note

Section 44AD has been substituted. However, since the new section is applicable from A.Y.2011-12, it is not applicable for May 2010 & November 2010 examinations. The provisions of new section 44AD are as follows -

(i) The presumptive taxation scheme, so far restricted to civil construction and retail trade, would now cover all small businesses with total turnover/gross receipts of up to Rs.40 lakh. Section 44AD has been substituted w.e.f. A.Y.2011-12, to include within its scope all such businesses (except the business of plying, hiring and leasing goods carriages covered under section 44AE). Consequently, section 44AF dealing with presumptive taxation for retail trade would not be applicable w.e.f. A.Y.2011-12 since retail trade would also fall within the scope of section 44AD.

(ii) Resident individuals, HUFs and partnership firms (but not LLPs) would be covered under this scheme.

(iii) The scheme would not apply to an assessee who is availing deductions under sections 10A, 10AA, 10B, 10BA or deduction under any provisions of Chapter VIA under the

heading "C.—Deductions in respect of certain incomes" in the relevant assessment year.

(iv) *The presumptive rate of tax would be 8% of total turnover or gross receipts. However, the assessee has the option to declare in his return of income, an amount higher than the presumptive income so calculated, claimed to have been actually earned by him.*

(v) *All deductions allowable under sections 30 to 38 shall be deemed to have been allowed in full and no further deduction shall be allowed. However, in the case of a firm, salary and interest would be allowed as deduction subject to the conditions and limits prescribed under section 40(b).*

(vi) *The written down value of any asset of such business shall be deemed to have been calculated as if the assessee had claimed and had been actually allowed the deduction in respect of depreciation for each of the relevant assessment years.*

(vii) *The intention of widening the scope of this scheme is to reduce the compliance and administrative burden on small businessmen and relieve them from the requirement of maintaining books of account. Such assessees opting for the presumptive scheme are not required to maintain books of account under section 44AA or get them audited under section 44AB.*

(viii) *Further, they would also be relieved from the requirement of advance tax payments. It would be sufficient compliance if they pay their tax while filing their return of income before the due date.*

(ix) *An assessee with turnover of upto Rs.40 lakh, who shows an income below the presumptive rate prescribed under these provisions, will, in case his total income exceeds the taxable limit, be required to maintain books of accounts under section 44AA and also get them audited under section 44AB.*

Thus, merely because an eligble assessee does not opt for presumptive taxation under section 44AD, it would not make him liable to maintain books of account under section 44AA or get the same audited under section 44AB. He will have to comply with these requirements only if his total income exceeds the taxable limit. If his total income does not exceed the taxable limit, the requirement of maintaining books of accounts under section 44AA and having the same audited under section 44AB would not arise.

(x) *In order to determine whether an assessee, who is engaged in multiple businesses, is eligble to opt for section 44AD, the limit of Rs.40 lakh should be applied business-wise and not by aggregating the turnover of all businesses of the assessee.*

(xi) ***Example***

Let us take the case of an assessee, say Mr. X, who has 3 businesses, the details of which are given hereunder -

Business	*Turnover during the P.Y.2010-11*
1. Retail trade	*Rs. 35 lakh*
2. Civil construction	*Rs. 45 lakh*
3. Catering	*Rs. 30 lakh*

In this case, Mr.X can opt for presumptive taxation under section 44AD in respect of his retail trade business and catering business, but not in respect of civil construction business (since the turnover of this business exceeds Rs.40 lakh). If Mr.X opts for presumptive taxation scheme, then his income from retail trade business would be Rs.2.80 lakh (i.e., 8% of Rs.35 lakh) and his income from catering business would be Rs.2.40 lakh (i.e., 8% of Rs.30 lakh). He is not required to maintain books of account for retail trade and catering business. However, since he cannot avail presumptive taxation scheme in respect of civil construction business, he has to maintain books of account under section 44AA and get them audited under section 44AB.

6.19 SPECIAL PROVISIONS FOR COMPUTING PROFITS AND GAINS OF BUSINESS OF PLYING, HIRING OR LEASING GOODS CARRIAGES [SECTION 44AE]

(i) This section provides for estimating business income of an owner of trucks from the plying, hire or leasing of such trucks;

(ii) The scheme applies to persons owning not more than 10 trucks at any time during the previous year;

(iii) The estimated income from each truck in case of a heavy goods vehicle will be deemed to be Rs.3,500 for every month or part of a month during which the truck is owned by the assessee for the previous year. The assessee can also declare a higher amount in his return of income. In such case, the latter will be considered to be his income;

(iv) In case of a truck, other than a heavy goods vehicle, the estimated income will be deemed to be Rs.3,150 for every month or part of the month during which such truck is owned by the assessee in the previous year. However, he may also declare a higher income and in such a case, the higher amount will be considered to be his income;

(v) The assessee will be deemed to have been allowed the deductions under sections 30 to 38. Accordingly, the written down value of any asset used for the purpose of the business of the assessee will be deemed to have been calculated as if the assessee had claimed and had actually been allowed the deduction in respect of depreciation for each of the relevant assessment years.

(vi) The assessee joining the scheme will not be required to maintain books of account under section 44AA and get the accounts audited under section 44AB in respect of such income.

An assessee may claim lower profits and gains than the deemed profits and gains specified in

sub-section (1) of that section subject to the condition that the books of account and other documents are kept and maintained as required under sub-section (2) of section 44AA and the assessee gets his accounts audited and furnishes a report of such audit as required under section 44AB.

Illustration 4

An assessee owns a light commercial vehicle for 9 months 15 days, a medium goods vehicle for 9 months and a medium goods vehicle for 12 months during the previous year. Compute his income applying the provisions of section 44AE

Solution

His profits and gains from the 3 trucks shall be deemed to be Rs.3,150 × 10 + Rs.3,150 × 9 + Rs.3,150 × 12 = Rs.97,650.

Illustration 5

An assessee owns a heavy goods vehicle for 9 months and 7 days, medium goods vehicle for 9 months and light commercial vehicle for 12 months during the previous year. Compute his income applying the provisions of section 44AE

Solution

His profits and gains from the 3 trucks shall be deemed to be Rs.3,500 × 10 + Rs.3,150 × 9 + Rs.3,150 × 12 = Rs.1,01,150.

Note – *The presumptive income per vehicle of transport operators under this scheme has been increased from Rs.3,150 per month to Rs.4,500 per month for vehicles other than heavy vehicles and from Rs.3,500 per month to Rs.5,000 per month for heavy vehicles with effect from A.Y.2011-12. (Month includes part of a month also). However, the assessee has the option to declare in his return of income, an amount higher than the presumptive income so calculated, claimed to have been actually earned by him from such vehicle.*

Example

Let us take the case of Mr.Y, who owns 5 heavy goods vehicles and 3 light goods vehicles. For the P.Y.2009-10, his presumptive income under section 44AE would be Rs.26,950 [(5 × 3,500) + (3 × 3,150)]. For the P.Y.2010-11, his presumptive income under section 44AE would be Rs.38,500 [(5 × 5,000) + (3 × 4,500)]. Therefore, consequent to this amendment, his presumptive income would go up by Rs.11,550 (i.e., Rs.38,500 – Rs.26,950) for the A.Y.2011-12.

Since this amendment is applicable from A.Y.2011-12, it is not applicable for May 2010 and November 2010 examinations.

6.20 SPECIAL PROVISIONS FOR COMPUTING PROFITS AND GAINS OF RETAIL TRADE BUSINESS [SECTION 44AF]

(i) This provision applies notwithstanding anything to the contrary contained in sections 28 to 43C. In the case of an assessee engaged in retail trade in any goods or merchandise 5% of the total turnover in the previous year on account of such business will be deemed to be the profits and gains of such business chargeable to tax under the head "profits and gains of business or profession". However, the assessee can declare a sum higher than the aforesaid sums.

(ii) This section will not apply in respect of an assessee whose turnover exceeds Rs. 40 lakh in a previous year.

(iii) Any deduction allowable under the provisions of sections 30 to 38 shall be deemed to have been already given full effect to and no further deduction under those sections shall be allowed.

(iv) Where the assessee is a firm, the salary and interest paid to its partners shall be deducted from the income computed above subject to the conditions and limits specified in section 40(b).

(v) The written down value of any asset used for the purposes of above business shall be deemed to have been calculated as if the assessee had claimed and had been actually allowed the deduction in respect of the depreciation for each of the relevant assessment years.

(vi) For these types of business sections 44AA and 44AB will not apply and in computing the monetary limits under those sections the total turnover or, as the case may be, the income from the said business shall be excluded.

An assessee may claim lower profits and gains than the deemed profits and gains specified in sub-section (1) of that section subject to the condition that the books of account and other documents are kept and maintained as required under sub-section (2) of section 44AA and the assessee gets his accounts audited and furnishes a report of such audit as required under section 44AB.

Note *– This section would not be relevant from A.Y.2011-12.*

6.21 SPECIAL PROVISION FOR COMPUTING THE PROFITS AND GAINS OF SHIPPING BUSINESS IN CASE OF NON-RESIDENTS [SECTION 44B]

(i) This section provides for computation of the profits and gains of the business of shipping carried on by non-residents to the extent they are chargeable to income-tax in India. According to this, a sum equal to 7½% of the aggregate of the following amounts must be deemed to be the profits and gains of the business of shipping chargeable to tax under the head 'profits and gains of business or profession'.

(ii) The amount paid or payable, whether within India or outside, to the assessee or to any person on his behalf on account of the carriage of passengers, livestock, mail or goods shipped at any port in India.

(iii) The amount received or deemed to be received in India by the assessee himself or by any other person on behalf of or on account of the carriage of passengers, livestock, mail or goods shipped at any port outside India.

The total of the above two amounts must be ascertained and 7½% thereof would be calculated and taken as the income from the business chargeable to tax in India. These provisions for computation of the income from the shipping business in case of non-residents would apply notwithstanding anything to the contrary contained in the provisions of sections 28 to 43A of the Income-tax Act. In other words, the income would be computed on this basis without applying the various provisions contained in sections 28 to 43A. Consequential provisions are also seen in section 172.

For the purposes of sub-section (2), receipts forming the basis of estimates on non resident shipping lines will include demurrage and handling charges.

6.22 PROVISIONS FOR COMPUTATION OF TAXABLE INCOME FROM ACTIVITIES CONNECTED WITH EXPLORATION OF MINERAL OILS [SECTION 44BB]

(i) The computation of taxable income of non-resident taxpayer engaged in the business of providing services and facilities in connection with or supplying plant and machinery on hire, used or to be used in the exploration for, and exploitation of mineral oils involves a number of complications.

(ii) As a measure of simplification, section 44BB provides for determination of income of such taxpayer at 10% of the aggregate of certain amounts. The amounts in respect of which the provisions will apply would be the amounts paid or payable to the taxpayer or to any person on his behalf whether in or out of India, on account of the provision of such services or facilities or supplying plant and machinery for the aforesaid purposes. This amount will also include facilities or supply of plant and machinery. This provision will not, however apply to any income to which the provisions of section 42, 44D, 115A or 293A apply. It may be noted that section 44BB applies only to non-resident assessees.

(iii) However, section 44BB has been amended to provide that such taxpayers may claim lower income than the present presumptive rate of 10%, if they keep and maintain books of accounts and documents as required under sub-section (2) of section 44AA and get their accounts audited under the provisions of section 44AB of the Act. The assessment in all such cases shall be done by the Assessing Officer under section 143(3) of the Act.

6.23 SPECIAL PROVISION FOR COMPUTING PROFITS AND GAINS OF THE BUSINESS OF OPERATION OF AIRCRAFT IN THE CASE OF NON-RESIDENTS [SECTION 44BBA]

Under section 44BBA(1), a sum equal to 5% of the aggregate of the amounts specified in sub-section (2) is deemed to be the profits and gains chargeable to tax under the head

"Profits and gains of business or profession". Sub-section (2) specifies the following amounts -

(a) the amount paid or payable, whether in or out of India, to the assessee or to any person on his behalf on account of the carriage of passengers, livestock, mail or goods from any place in India; and

(b) the amount received or deemed to be received in India by or on behalf of the assessee on account of the carriage of passengers, livestock, mail or goods from any place outside India.

Illustration 6

Mr. Tiwari, a non-resident, operates an aircraft between Bangkok and Mumbai. He received the following amounts in the course of the business of operation of aircraft during the year ending 31.3.2010:

(i) Rs.3 crore in India on account of carriage of passengers from Mumbai.

(ii) Rs.2 crore in India on account of carriage of goods from Mumbai.

(iii) Rs.1 crore in India on account of carriage of passengers from Bangkok.

(iv) Rs.2 crore in Bangkok on account of carriage of passengers from Mumbai.

The total expenditure incurred by Mr. Tiwari for the purposes of the business during the year ending 31.3.2010 was Rs.1.8 crore.

Compute the income of Mr. Tiwari chargeable to tax in India under the head “Profits and gains of business or profession” for the assessment year 2010-11.

Solution

Keeping in view the provisions of section 44BBA, the income of Mr. Tiwari chargeable to tax in India under the head "Profits and gains of business or profession" is worked out hereunder -

	Rs.
Amount received in India on account of carriage of passengers from Mumbai	3,00,00,000
Amount received in India on account of carriage of goods from Mumbai	2,00,00,000
Amount received in India on account of carriage of passengers from Bangkok	1,00,00,000
Amount received in Bangkok on account of carriage of passengers from Mumbai	2,00,00,000
	8,00,00,000

6.94 Income Tax

Income from business under section 44BBA at 5% of Rs.8,00,00,000 is Rs.40,00,000, which is the income of Mr.Tiwari chargeable to tax in India under the head "Profits and gains of business or profession" for the A.Y.2010-11.

6.24 SPECIAL PROVISION FOR COMPUTING PROFITS AND GAINS OF FOREIGN COMPANIES ENGAGED IN THE BUSINESS OF CIVIL CONSTRUCTION ETC. IN CERTAIN TURNKEY POWER PROJECTS [SECTION 44BBB]

(i) Under this provision in the case of a foreign company engaged in the business of construction or the business of erection of plant or machinery or testing or commissioning thereof in connection with a turnkey power project approved by the Central Government in this behalf, a sum equal to 10% of the amount paid or payable (whether in or out of India) to the said assessee or to any person on his behalf on account of such civil construction, erection, testing or commissioning shall be deemed to be the profits and gains of such business chargeable to tax under the head 'profits and gains of business or profession'.

(ii) However, section 44BBB has been amended to provide that such taxpayers may claim lower income than the present presumptive rate of 10%, if they keep and maintain books of accounts and documents as required under sub-section (2) of section 44AA and get their accounts audited under the provisions of section 44AB of the Act. The assessment in all such cases shall be done by the Assessing Officer under section 143(3) of the Act.

6.25 SPECIAL PROVISIONS FOR COMPUTING INCOME BY WAY OF ROYALTIES ETC. IN CASE OF NON-RESIDENTS [SECTION 44DA]

The provisions of this section are as follows -

(i) The income by way of royalty or fees for technical services received from Government or an Indian concern in pursuance of an agreement made by a non-corporate non-resident or a foreign company with Government or the Indian concern after the 31st March, 2003 in respect of such non-corporate non-resident or a foreign company which carries on business in India, shall be computed on the basis of books of accounts required to be maintained under the Act.

(ii) Such business should be carried on through a permanent establishment, or the assessee should perform professional services from a fixed place of profession in India

(iii) They should keep and maintain books of account and other documents in accordance with the provisions contained in section 44AA.

(iv) They should get their accounts audited by an accountant as defined in the Explanation below sub-section (2) of section 288 and furnish along with the return of income, the report of such audit in the prescribed form duly signed and verified by such accountant.

(v) No deduction will be allowed while computing income of such non-resident, of the

expenditure which is not wholly and exclusively incurred for the business of such permanent establishment or fixed place and also of any amount paid by the permanent establishment to its head office or any of its offices.

6.26 METHOD OF COMPUTING DEDUCTION IN THE CASE OF BUSINESS REORGANISATION OF CO-OPERATIVE BANKS [SECTION 44DB]

(i) This section provides the manner in which the deduction under the following sections are to be allowed in a case where business reorganisation of a co-operative bank has taken place during the financial year –

(1) Section 32 (Depreciation);

(2) Section 35D (Amortisation of certain preliminary expenses);

(3) Section 35DD (Amortisation of expenses in case of amalgamation or demerger);

(4) Section 35DDA (Amortisation of expenditure incurred under voluntary retirement scheme).

(ii) Business reorganisation means the reorganisation of business involving the amalgamation or demerger of a co-operative bank.

(iii) Co-operative bank shall have the meaning assigned to it in clause (cci) of section 5 of the Banking Regulation Act, 1949 i.e., a primary co-operative bank or Central Co-operative bank or a State co-operative bank.

(iv) Predecessor co-operative bank means the amalgamating co-operative bank or the demerged co-operative bank, as the case may be.

(v) Successor co-operative bank means the amalgamated co-operative bank or the resulting bank, as the case may be.

(vi) The amount of deduction allowable to the predecessor co-operative bank under the above-mentioned sections has to be determined in accordance with the following formula-

$$A \times \frac{B}{C}$$

A = the amount of deduction allowable to the predecessor co-operative bank if the business reorganisation had not taken place;

B = the number of days comprised in the period beginning with the 1st day of the financial year and ending on the day immediately preceding the date of business reorganisation; and

C = the total number of days in the financial year in which the business reorganisation has taken place.

(vii) The amount of deduction allowable to the successor co-operative bank under the above-mentioned sections has to be determined in accordance with the formula -

$$A \times \frac{B}{C}$$

A = the amount of deduction allowable to the predecessor co-operative bank if the business reorganisation had not taken place;

B = the number of days comprised in the period beginning with the date of business reorganisation and ending on the last day of the financial year; and

C = the total number of days in the financial year in which the business reorganisation has taken place.

For example, let us take a case where the deduction allowable under section 32 to the predecessor co-operative bank is, say, Rs.1,20,000 and the business re-organisation took place on 1.11.09. Then, the deduction allowable to the predecessor co-operative bank under section 32 would be Rs.70,356 i.e. Rs.1,20,000 x 214 / 365. The deduction allowable to the successor co-operative bank would be Rs.49,644 i.e. Rs.1,20,000 x 151/365.

(viii) In a case where an undertaking of the predecessor co-operative bank entitled to the deduction under sections 35D, 35DD or 35DDA is transferred before the expiry of the period specified therein to a successor co-operative bank on account of business reorganisation, the provisions of section 35D, section 35DD or section 35DDA shall apply to the successor co-operative bank in the financial years subsequent to the year of business reorganisation as they would have applied to the predecessor co-operative bank, as if the business reorganisation had not taken place.

(ix) Amalgamated co-operative bank means -

(1) a co-operative bank with which one or more amalgamating co-operative banks merge; or

(2) a co-operative bank formed as a result of merger of two or more amalgamating co-operative banks.

(x) Amalgamating co-operative bank means -

(1) a co-operative bank which merges with another co-operative bank; or

(2) every co-operative bank merging to form a new co-operative bank.

(xi) Amalgamation means the merger of an amalgamating co-operative bank or banks with

an amalgamated co-operative bank, in such a manner that -

(1) all the assets and liabilities of the amalgamating co-operative bank or banks immediately before the merger (other than the assets transferred, by sale or distribution on winding up, to the amalgamated co-operative bank) become the assets and liabilities of the amalgamated co-operative bank;

(2) the members holding 75% or more voting rights in the amalgamating co-operative bank become members of the amalgamated co-operative bank; and

(3) the shareholders holding 75% or more in value of the shares in the amalgamating co-operative bank (other than the shares held by the amalgamated co-operative bank or its nominee or its subsidiary, immediately before the merger) become shareholders of the amalgamated co-operative bank.

(xii) Demerger means the transfer by a demerged co-operative bank of one or more of its undertakings to any resulting co-operative bank, in such manner that -

(1) all the assets and liabilities of the undertaking or undertakings immediately before the transfer become the assets and liabilities of the resulting co-operative bank;

(2) the assets and the liabilities are transferred to the resulting co-operative bank at values (other than change in the value of assets consequent to their revaluation) appearing in its books of account immediately before the transfer;

(3) the resulting co-operative bank issues, in consideration of the transfer, its membership to the members of the demerged co-operative bank on a proportionate basis;

(4) the shareholders holding 75% or more in value of the shares in the demerged co-operative bank (other than shares already held by the resulting bank or its nominee or its subsidiary immediately before the transfer), become shareholders of the resulting co-operative bank, otherwise than as a result of the acquisition of the assets of the demerged co-operative bank or any undertaking thereof by the resulting co-operative bank;

(5) the transfer of the undertaking is on a going concern basis; and

(6) the transfer is in accordance with the conditions specified by the Central Government, by notification in the Official Gazette, having regard to the necessity to ensure that the transfer is for genuine business purposes.

(xiii) Demerged co-operative bank means the co-operative bank whose undertaking is transferred, pursuant to a demerger, to a resulting bank.

(xiv) Resulting co-operative bank means -

(1) one or more co-operative banks to which the undertaking of the demerged co-operative bank is transferred in a demerger; or

(2) any co-operative bank formed as a result of demerger.

Illustration 7

Alpha Co-operative Bank amalgamated with Beta Co-operative Bank on 1.12.2009. The depreciation for the year ended 31.3.2010 calculated as per Income-tax Rules allowable to Alpha Co-operative Bank had the amalgamation had not taken place amounts to Rs.2,40,000. Compute the deduction on account of depreciation allowable in the hands of Alpha Co-operative Bank and Beta Co-operative Bank for A.Y. 2010-11.

Solution

(i) The amount of deduction allowable to the amalgamating co-operative bank (i.e. Alpha Co-operative bank, in this case) under section 32 has to be determined in accordance with the following formula -

$$A \times \frac{B}{C}$$

A = the amount of deduction allowable to the predecessor co-operative bank (i.e. Alpha Co-operative bank, in this case) if the business reorganisation had not taken place. In this case, the amount of deduction is Rs.2,40,000.

B = the number of days comprised in the period beginning with the 1st day of the financial year (i.e. 1.4.2009, in this case) and ending on the day immediately preceding the date of business reorganization (i.e. 30.11.2009, in this case); and

C = the total number of days in the financial year in which the business reorganisation has taken place (i.e. 365 days).

(ii) The amount of deduction allowable to the amalgamated co-operative bank (i.e. Beta Co-operative bank, in this case) under section 32 has to be determined in accordance with the formula -

$$A \times \frac{B}{C}$$

A = the amount of deduction allowable to the predecessor co-operative bank (i.e. Alpha Co-operative bank, in this case) if the business reorganisation had not taken place. In this case, the amount of deduction is Rs.2,40,000.

B = the number of days comprised in the period beginning with the date of business reorganisation (i.e. 1.12.2009, in this case) and ending on the last day of the financial year (i.e. 31.3.2010); and

C = the total number of days in the financial year in which the business reorganisation has taken place (i.e. 365 days).

(iii) In this case, the deduction that would have been allowable under section 32 to Alpha co-operative bank had the business reorganization had not taken place is Rs.2,40,000 and the business re-organisation took place on 1.12.09. Therefore, the deduction allowable to Alpha co-operative bank under section 32 would be Rs.1,60,438 i.e. Rs.2,40,000 x 244/365. The deduction allowable to Beta co-operative bank would be Rs.79,562 i.e. Rs.2,40,000 x 121/365.

6.27 COMPUTATION OF BUSINESS INCOME IN CASES WHERE INCOME IS PARTLY AGRICULTURAL AND PARTLY BUSINESS IN NATURE

(i) Income from the manufacture of rubber [Rule 7A]

(1) Income derived from the sale of centrifuged latex or cenex or latex based crepes or brown crepes or technically specified block rubbers manufactured or processed from field latex or coagulum obtained from rubber plants grown by the seller in India shall be computed as if it were income derived from business, and 35% of such income shall be deemed to be income liable to tax.

(2) In computing such income, an allowance shall be made in respect of the cost of planting rubber plants in replacement of plants that have died or become permanently useless in an area already planted, if such area has not previously been abandoned, and for the purpose of determining such cost, no deduction shall be made in respect of the amount of any subsidy which, under the provisions of clause (31) of section 10, is not includible in the total income.

(ii) Income from the manufacture of coffee [Rule 7B]

(1) Income derived from the sale of coffee grown and cured by the seller in India shall be computed as if it were income derived from business, and 25% of such income shall be deemed to be income liable to tax.

(2) Income derived from the sale of coffee grown cured, roasted and grounded by the seller in India, with or without mixing of chicory or other flavouring ingredients, shall be computed as if it were income derived from business, and 40% of such income shall be deemed to be income liable to tax.

(3) In computing such income, an allowance shall be made in respect of the cost of planting coffee plants in such replacement of plants that have died or become permanently useless in an area already planted, if such area has not previously been abandoned, and for the purpose of determining such cost, no deduction shall be made in respect of the amount of any subsidy which, under the provisions of clause (31) of section 10, is not includible in the total income.

(iii) Income from the manufacture of tea [Rule 8]

(1) Income derived from the sale of tea grown and manufactured by the seller in India shall be computed as if it were income derived from business, and 40% of such income shall be deemed to be income liable to tax.

(2) In computing such income an allowance shall be made in respect of the cost of planting bushes in replacement of bushes that have died or become permanently useless in an area already planted, if such area has not previously been abandoned, and for the purpose of determining such cost, no deduction shall be made in respect of the amount of any subsidy which, under the provision of clause (31) of section 10, is not includible in the total income.

Self examination questions

1. Is it compulsory for an assessee to claim depreciation under section 32 of the Income-tax Act, 1961?
2. Write short notes on -
   (i) Enhanced depreciation
   (ii) Set-off and carry forward of unabsorbed depreciation.
3. Discuss the provisions dealing with the computation of business income on a presumptive basis in case of resident assessees.
4. Discuss the concept of "block of assets" under the Income-tax Act, 1961.
5. Which are the deductions allowable only on actual payment under section 43B?
6. Write short notes on the following -
   (a) Compulsory maintenance of books of accounts
   (b) Compulsory tax audit.
7. What is the tax treatment regarding cash payments in excess of limits prescribed in section 40A(3)?
8. Discuss the provision for computing income by way of royalties or fees for technical services as provided for in section 44DA.
9. What are the conditions to be satisfied for an expenditure to be allowed as deduction under section 37(1)?
10. The written down value of plant and machinery in the books of Alpha Ltd. is 75,00,000 as on 1st April, 2009, on which date, the installed capacity of the company was 12,000 tons. Alpha Ltd. borrowed Rs.10,00,000@10%p.a. from ICICI Bank on 1.8.09 for purchase of new plant and machinery for extension of its existing

business, which would increase its installed capacity to 13,000 tons. The new plant and machinery was purchased on the same date but was put to use only w.e.f. 1.11.09. Compute the depreciation admissible under section 32 for the A.Y.2010-11, assuming the applicable rate of depreciation on plant and machinery to be 15%.

11. A Ltd. was a wholly owned subsidiary company of B Ltd. An agreement was entered into between B Ltd. and A Ltd., by which the textile unit belonging to B Ltd. was transferred to A Ltd.. The agreement provided, inter-alia, for continuity of service of workmen who were employed in the textile unit of B Ltd. taken over by A Ltd. and the agreement also protected the conditions of service of workmen. B Ltd. delivered possession of the properties to A Ltd. and the employees of B Ltd. working in the textile unit were transferred to A Ltd. with the benefit of continuity of service. For the subsequent two assessment years, A Ltd. claimed deduction of a certain sum as gratuity payment to workers (who were erstwhile employees of B Ltd.), who had retired during the relevant previous years. The Assessing Officer disallowed the same on the ground that the liability of A Ltd. towards gratuity payment for the employees for the services rendered by them in the period prior to the takeover of the unit would be a capital expenditure. Is the reasoning of the Assessing Officer correct? Discuss.

12. Alpha Ltd., a running concern, received interest on the loans/advances made by it to its debtors. It contended that such interest was to be treated as business income. Discuss the correctness of the contention of Alpha Ltd., if such interest was not on account of delayed payment towards sales or compensation/damages or an item relatable to its business.

13. The assessee-firm had received a sum of money of Rs.5,25,250 in the P.Y.2009-10 towards credit note of excise duty. Out of the said sum, the assessee did not refund an amount of Rs.2,10,000 to its customers and credited the same to its profit and loss account. The amount has also been distributed amongst the partners. The Assessing Officer added the said amount to the total income of the assessee. On appeal, the Commissioner (Appeals), however, set aside the order of the Assessing Officer. Discuss, giving reasons, whether the Assessing Officer is correct or the Commissioner (Appeals) is correct?

14. Moon Hotels Ltd., the assessee, along with two other entities, was a partner in a firm which was engaged in hotel business. A memorandum of understanding was executed by which it was decided that the other partners would disassociate from the firm and the assessee would continue the business of the firm. Accordingly, a dissolution deed was executed by which it was agreed that the assessee would take over all the assets of the firm and in consideration, the assessee would pay to the retiring partners, 30% of the net profits of the business, subject to a minimum amount of Rs.60,000 for a period of 7 years. The dissolution deed did not refer to any capital

sum anywhere. During the previous year 2009-10, as per the terms of dissolution deed, the assessee paid Rs.75,000 to the retired partners and claimed deduction of such sum as business expenditure. The Assessing Officer disallowed the amount paid by the assessee to the retired partners on the ground that the payment was capital in nature. Discuss the correctness of the contention of the Assessing Officer.

15. Are expenditure incurred by a company on account of stamp duty and registration fees for the issue of bonus shares allowable as revenue expenditure?

16. XYZ Ltd. donated a bus to a school where the employee's children were studying and debited the same to the Workmen and Staff Welfare Account. It claimed the expenditure as deduction on the ground that it was incurred wholly and exclusively for the purpose of the assessee's business. Discuss whether the contention of the assessee is correct.

17. The assessee was a dealer in two-wheelers manufactured by TVS Suzuki Ltd. It was carrying on its business in leasehold premises. The assessee constructed a ground floor above the existing basement floor according to the specifications given by TVS Suzuki Ltd. to all its dealers. As per the stipulation in the lease deed, reimbursement of such expenditure from the owner of the premises was also not possible. The assessee claimed the expenses incurred for construction as revenue expenditure for the relevant assessment year. Can such expenditure be allowed as a revenue expenditure?

18. The assessee was a manufacturer of textiles who made contribution towards export development fund. The assessee claimed that in order to augment its own export sales and give competitive edge to its marketing, it had contributed to the fund in its own business expediency, with the object of increasing opportunity of export of goods manufactured by it and to earn the subsidy. The assessee, therefore, claimed deduction on account of the same. Is the contention of the assessee correct?

19. Rallis Ltd. was situated in a remote place and its employees were the members of a club. The club was the only source of recreation to the employees. Rallis Ltd. paid a sum of Rs.5 lakhs to the club for renovation and repairs of the club building which had been damaged. Rallis Ltd. claimed deduction of the same as business expenditure. Discuss whether its claim is tenable in law?

20. ABC Pvt. Ltd. had in the course of carrying on of its business, obtained unsecured loans from various creditors. In the light of the financial difficulties faced by the company, the creditors approached the High Court by filing various company petitions. During the course of those proceedings, a compromise was reached between the company and its creditors wherein, as per the terms of the compromise, certain creditors remitted unsecured loans amounting to Rs.1,77,052 and interest amounting to Rs.2,96,171. ABC Pvt. Ltd. declared such remitted interest as income

liable to tax under section 41(1), while filing its return of income. The Assessing Officer, however, contended that the remittance of unsecured loan was also a benefit accruing to the company during the course of its business activity and brought the same to tax. Discuss the correctness of the contention of the Assessing Officer, keeping in mind that there was no allowance or deduction in any of the previous years in respect of such unsecured loan.

21. Alpha Ltd is a public limited company. As a good corporate citizen and as a measure of gaining goodwill of the people living in and around its industry, which is to some extent a polluting industry, it provided funds for establishing drinking water facilities to the residents in the vicinity of the refinery and also provided aid to the school run for the benefit of the children of those local residents. The Assessing Officer declined to allow that expenditure on the ground that it was not an item of expenditure incurred by the assessee for earning the income. The company, however, claimed that such social costs can be claimed as deduction. Is the claim of Alpha Ltd. tenable in law? Discuss.

22. The scheme of amalgamation of A Ltd. with B Ltd. was sanctioned by the High Court on 1.5.2009. However, the amalgamation was effective from 1.1.2009. A Ltd. incurred Rs.2.3 lakhs during the previous year 2008-09 towards legal expenses in connection with its amalgamation with B Ltd. A Ltd. contended that such expenses were revenue in nature and hence, were to be allowed as deduction for previous year 2008-09. Discuss the correctness of the contention of A Ltd., if such amalgamation is resorted to by A Ltd. for the smooth and efficient conduct of the business through the transferee-company, namely, B Ltd.

23. ABC Ltd. is a public sector undertaking. One of its objects is to promote co-operative societies. In the audited accounts for the relevant assessment year, investment in shares of various co-operative societies to the extent of Rs.80 lakh had been written off in the profit and loss account considering the fact that the said co-operative societies were either defunct or under liquidation. The Assessing Officer disallowed the loss claimed by the assessee on the ground that it was a capital loss. Do you support the treatment given by the assessee or the view of the Assessing Officer. You are required to give your answer taking into account the following -

    (i) The memorandum and articles of association of the assessee did not provide for either withdrawing shares or transferring shares held in co-operative societies under any circumstance.

    (ii) The reduction in value of shares was effected through book entries only and there was no actual transfer of shares.

24. (a) Can a bank guarantee be equated with actual payment as required under section 43B for allowance as deduction in computation of profits?

(b) Can interest payable to sales tax department also be considered as a "tax" under the provisions of section 43B?

Answers

11. This issue came up before the Madras High Court in *Sree Akilandeswari Mills (P.) Ltd. v. Dy. CIT (2005) 145 Taxman 474 / 274 ITR 0001.* The High Court observed that as far as the gratuity liability is concerned, the obligation to pay gratuity on the part of the assessee to all its employees for the service rendered in a particular year is a definite and ascertainable liability on the basis of actuarial valuation. The assessee, by virtue of the deed of transfer, had taken over the liability of the transferor-company towards gratuity of the employees of the transferor-company on the date of transfer. The gratuity liability was an ascertained liability on the basis of actuarial valuation and this liability, which formed part of the sale consideration, was discharged later by actual payment by the assessee to the employees in subsequent years. The Court held that if an ascertained liability of the predecessor on the date of transfer was taken over by the successor in business, and later on it was discharged, the expenditure incurred would be capital in nature and is not allowable as business expenditure.

Hence, in this case, the expenditure incurred by A Ltd., towards discharge of the gratuity liability of the employees of the unit taken over from B Ltd., is a capital expenditure. Therefore, the reasoning of the Assessing Officer is correct.

12. The Allahabad High Court, in *CIT v. Radico Khaitan Ltd. (2005) 12 Taxman 681 / 274 ITR 0354*, observed that under section 14, the various heads of income have been specified. If an item does not fall under any of the heads enumerated in Heads A to E mentioned in section 14, it would fall under the residuary head - Head F i.e. 'Income from other sources'.

The High Court further observed that the assessee-company had received interest on loans/advances made by it to its debtors. The amount of interest was not relatable to any late payment of the invoices/bills or compensation/damages. Thus, the amount of interest which it had received could not, by any stretch of imagination, be treated as income from business but was to be treated under the head 'Income from other sources'.

Thus, in view of the above case, the contention of Alpha Ltd. is not correct.

13. This question came up before the Allahabad High Court in *CIT v. London Machinery Company (2005) 146 Taxman 326.* The High Court observed that the provisions of section 41(1) would be attracted if the following conditions are satisfied –

(1) An allowance or deduction has been made in the assessment for any year in respect of loss, expenditure or trading liability incurred by the asssessee.

(2) Subsequently, during any previous year, the assessee must have obtained -

(i) any amount in respect of such loss; or

(ii) any benefit in respect of such trading liability by way of remission or cessation thereof.

In case either of the events mentioned in (2) above happen, the deeming provision enacted in the closing part of sub-section (1) of section 41 comes into play. Accordingly, the amount obtained by the assessee or the value of benefit accruing to him is deemed to be the profits and gains of business or profession and it becomes chargeable to income-tax as the income of that previous year. The transfer of unpaid excise credit to the profit and loss account of the assessee falls under the first clause of section 41(1) [as stated in 2(i) above] and is, therefore, chargeable to tax as profit of the year.

Therefore, in this case, the view taken by the Assessing Officer is correct since the first clause of section 41(1) is attracted. The amount of Rs.2,10,000 on account of unpaid excise credit received by the assessee-firm and credited to its profit and loss account and not passed on to its customers is chargeable as profits of the firm for the previous year 2009-10.

14. The facts of this case are similar to the case decided by the Bombay High Court in *CIT v. Mandovi Hotel (P.) Ltd. (2006) 152 Taxman 361*. The High Court observed that the payment of 30% of net profits was related to annual profits that flowed from the business activities of the assessee-company and not to the capital value of the assets. Further, the dissolution deed did not specify any capital sum payable to the retiring partners. Therefore, the payment of 30% of the annual profits cannot be held to be the fixed price for purchase of the capital assets. Thus, the agreement between the parties which was reflected by the dissolution deed and memorandum of understanding showed that the payment made by the assessee to the retired partners was related to the annual profits that flowed from the activities of the assessee and it could not be said to have any relation to the capital value of the assets of the estate. The payment so made was also not related or tied up in any way to any fixed sum agreed between the parties as part of the consideration to the retiring partners for disassociating from the firm. Hence, the expenditure cannot be construed as a capital expenditure.

Therefore, in this case, the contention of the Assessing Officer is not correct.

15. This issue has been settled by the Supreme Court in *CIT v. General Insurance Corporation (2006) 286 ITR 232*. The Supreme Court observed that there is no inflow of fresh funds or increase in capital employed on account of issue of bonus shares. There is merely a reallocation of company's fund on account of issue of bonus shares by capitalization of reserves. Therefore, the company has not acquired a benefit or advantage of enduring nature. The total funds available with the company will remain the same and there is no change in the capital structure of the company consequent to the bonus issue. Thus, issue of bonus shares does not result in the expansion of capital base of the company. Therefore, the expenditure incurred by the company on account of stamp duty and registration fees for the issue of bonus shares is allowable as revenue expenditure.

16. This issue came up before the Rajasthan High Court in *CIT v. Rajasthan Spinning and Weaving Mills Ltd. (2006) 281 ITR 408***.** The High Court observed that the contention of the assessee, that such expenses were incurred for the welfare of the children of staff/workmen of the company as part of the employee welfare expenses for the purpose of securing efficient services of such employees, was true. Since the assessee had not acquired any asset, it was not a capital expenditure. Therefore, the expenditure was deductible.

17. This question was answered by the Madras High Court in *CIT v. Hari Vignesh Motors P. Ltd. (2006) 282 ITR 0338*. The High Court observed that the assessee had undertaken the construction in view of the requirements of the business. The assessee did not acquire any capital asset by incurring the expenditure. As per the stipulation in the lease deed, reimbursement of such expenditure from the owner of the premises was also not possible. The High Court, therefore, held that the expenditure was revenue in nature and can be allowed as deduction.

18. This question came up for consideration before the Rajasthan High Court in *Additional Commissioner of Income-tax v. Rajasthan Spinning & Weaving Mills Ltd. (2004) 137 Taxman 367.* The Court observed that the fund was set up to promote export of textiles and therefore contribution to such fund had direct nexus to the advancement of the assessee's business. Participation in any trade, association or fund set up for advancement of business, which is also carried on by the assessee, is primarily for advancing assessee's own business and not for philanthropic purposes. The High Court held that such expenses were incurred and laid out wholly and exclusively for the purpose of the assessee's business, and hence were allowable as deduction under section 37(1).

Therefore, in this case, the contention of the assessee is correct.

19. This issue came up for consideration before the Calcutta High Court in *Assam Brook Ltd. v. Commissioner of Income-tax (2004) 139 Taxman 229.* The High Court observed that since the company was situated in a remote place, the club was the only source of recreation for its employees, who were also members of the club. So, if the assessee-company paid some amount for the upliftment/running of the club in an effective way, then such payment was made in the interest of the assessee, so that its employees remained happy and, consequently, the work of the assessee was not hampered in any way due to dissatisfaction on the part of the employees. As the payment of Rs.5 lakhs was made by the assessee to the club keeping its business interest in mind, the said payment must be held to be business expenditure, and accordingly, as per section 37 the assessee-company was entitled to get deduction.

The claim of Rallis Ltd. is, therefore, tenable in law.

20. This issue came up for consideration before the Gujarat High Court in *CIT v. Chetan Chemicals (P.) Ltd. (2004) 139 Taxman 301.* The High Court observed that section 41(1) can be invoked only when an allowance or a deduction has been granted during the course of assessment for any year in respect of loss, expenditure or trading liability which is incurred by the assessee, and subsequently, during any

previous year, the assessee obtains, whether in cash or in any other manner, any amount in respect of such trading liability by way of remission or cessation of such liability. In that case, either the amount obtained by the assessee or the value of the benefit accruing to the assessee can be deemed to be the profits and gains of a business or profession and can be brought to tax as income of the previous year in which such amount or benefit is obtained. In this case, since there had been no allowance or deduction in any of the preceding years in respect of the unsecured loan, the provisions of section 41(1) cannot be applied to such loan.

Therefore, the amount of Rs.1,77,052 arising as a result of remission of unsecured loans is not taxable in the hands of ABC Pvt Ltd.

21. The Madras High Court has recognized the relevance of social costs to business in deciding the case of *CIT v. Madras Refineries Ltd. (2004) 138 Taxman 261*. The High Court observed that the concept of business is not static. It has evolved over a period of time to include within its fold the concrete expression of care and concern for the society at large and the people of the locality in which the business is located in particular. Further, to be known as a good corporate citizen brings goodwill of the local community, as also with the regulatory agencies and the society at large, thereby creating an atmosphere in which the business can succeed in a greater measure with the aid of such goodwill. In this case, the High Court upheld the order of the Tribunal allowing deduction for the amount spent on bringing drinking water to the locality and in aiding a local school.

Thus, in view of the above case, the claim of Alpha Ltd. is tenable in law.

22. A similar question arose before the Gujarat High Court in *CIT v. Akme Electronics & Control (P.) Ltd. (2004) 137 Taxman 263*. The High Court held that when the legal expenses were to be paid in connection with the amalgamation of the assessee-company with another company, the liability to pay legal expenses arose in respect of the period when the amalgamating company still continued to exist. The effective date of amalgamation in many cases may even be a date prior to the date of sanction of the scheme, but so long as the scheme was not sanctioned, the transferor-company continued to exist and since the amalgamation was resorted to for the smooth and efficient conduct of the business through the transferee-company, the legal expenses were deemed to be laid out wholly and exclusively for the purpose of the business of the amalgamating assessee-company.

Therefore, in this case, the contention of A Ltd. is correct. A Ltd. can claim Rs.2.3 lakhs as revenue expenditure for the previous year 2008-09, when A Ltd. continued to exist, since the scheme of amalgamation was yet to be sanctioned during that previous year.

23. This question came up before the Kerala High Court in *Kerala Small Industries Development Corporation Ltd. v. CIT (2004) 140 Taxman 509*. The High Court observed that the memorandum and articles of association of the assessee did not provide for either withdrawing shares or transferring shares held in co-operative societies under any circumstance. Therefore, the investment made by the assessee

in the capital of co-operative societies could not be viewed as part of its trading/circulating capital. Hence, any loss on shares representing investment of the assessee cannot be termed as trading/revenue loss. The High Court further observed that reduction in value of shares was effected through book entries only and there was no actual transfer of shares. Therefore, it could not even be construed as a capital loss arising out of trading in capital assets.

In view of the above decision, the loss in this case cannot be treated as a revenue loss. Further, since the reduction in value of shares was effected only through book entries, there has been no transfer as contemplated in section 2(47) and hence, there is no question of any capital loss.

24. (a) The Rajasthan High Court, in *CIT v. Udaipur Distillery Co. Ltd. (2004) 134 Taxman 398,* observed that the requirement of section 43B is the actual payment and not deemed payment of any of the expenses (as specified in section 43B) incurred by the assessee during the relevant previous year for claiming the deduction. Furnishing bank guarantee cannot be equated with actual payment. Actual payment requires that money must flow from the assessee to the public exchequer as such as specified in section 43B.

(b) The Rajasthan High Court, in *Mewar Motors v. CIT (2004) 135 Taxman 155,* opined that the amount of interest paid is part of the sales tax and the provisions of section 43B are applicable to it.

7

CAPITAL GAINS

7.1 INTRODUCTION

In this chapter on capital gains, the discussion begins with the definition of capital asset and transfer and then the various circumstances under which capital gains tax is levied are enumerated. There are certain transactions which are not to be regarded as transfer for the purposes of capital gains. These transactions have also been discussed in this chapter. For computing long-term capital gains, knowledge of cost inflation index is necessary. Again, there is a separate method of computation of capital gains in respect of depreciable assets. Also, there are exemptions from capital gains under certain circumstances. All these are discussed in this chapter.

Section 45 provides that any profits or gains arising from the transfer of a capital asset effected in the previous year will be chargeable to income-tax under the head 'Capital Gains'. Such capital gains will be deemed to be the income of the previous year in which the transfer took place. In this charging section, two terms are important. One is "capital asset" and the other is "transfer".

7.2 CAPITAL ASSET

(1) DEFINITION

According to section 2(14), a capital asset means property of any kind held by an assessee, whether or not connected with his business or profession, but does not include—

(i) any stock-in-trade, consumable stores or raw materials held for the purpose of the business or profession of the assessee;

(ii) personal effects, that is to say, movable property (including wearing apparel and furniture) held for personal use by the assessee or any member of his family dependent on him, but excludes

(a) jewellery;

(b) archaeological collections;

(c) drawings;

(d) paintings;

(e) sculptures; or

(f) any work of art.

Note - Jewellery includes -

(a) ornaments made of gold, silver, platinum or any other precious metal or any alloy containing one or more of such precious metals, whether or not containing any precious or semi-precious stone, and whether or not worked or sewn into any wearing apparel;

(b) precious or semi-precious stones, whether or not set in any furniture, utensil or other article or worked or sewn into any wearing apparel.

(iii) Rural agricultural land in India i.e. agricultural land in India which is not situated in any specified area.

(iv) 6½% Gold Bonds, 1977, or 7% Gold Bonds, 1980, or National Defence Gold Bonds, 1980, issued by the Central Government;

(v) Special Bearer Bonds, 1991 issued by the Central Government;

(vi) Gold Deposit Bonds issued under the Gold Deposit Scheme, 1999 notified by the Central Government.

(2) Rural Agricultural Lands - We can note from the above definition that only rural agricultural lands in India are excluded from the purview of the term 'capital asset'. Hence urban agricultural lands constitute capital assets. Accordingly, agricultural land situated within the limits of any municipality or cantonment board having a population of 10,000 or more according to the latest census will be considered as capital asset. Further, agricultural land situated in areas lying within a distance of 8 kms from the local limits of such municipality or cantonment board will also be considered as capital asset. The condition here is that such areas must be notified by the Central Government having regard to the extent and scope of their urbanisation and other relevant considerations. Consequently, any capital gain arising from the transfer of the abovementioned agricultural lands will be liable to income-tax.

Explanation regarding gains arising on the transfer of urban agricultural land - The Explanation to section 2(1A) clarifies that capital gains arising from transfer of any agricultural land situated in any non-rural area (as explained above) will not constitute agricultural revenue within the meaning of section 2(1A). In other words, the capital gains arising from the transfer of such urban agricultural lands would not be treated as agricultural income for the purpose of exemption under section 10(1). Hence, such gains would be exigible to tax under section 45.

(3) Other capital assets - It is not possible to enumerate the forms which a capital asset can take. Goodwill, leasehold rights, a partner's right or share in the firm, a manufacturing licence and the right to subscribe for share of a company etc. are all examples of capital asset.

(4) Jewellery - As noted above, jewellery is treated as capital asset and the profits or gains arising from the transfer of jewellery held for personal use are chargeable to tax under the head "capital gains". For this purpose, the expression 'jewellery' includes the following:

(i) Ornaments made of gold, silver, platinum or any other precious metal or any alloy containing one or more of such precious metals, whether or not containing any precious or semi-precious stones and whether or not worked or sewn into any wearing apparel;

(ii) Precious or semi-precious stones, whether or not set in any furniture, utensil or other article or worked or sewn into any wearing apparel.

(5) Zero Coupon Bond – Section 2(48) defines the expression 'Zero Coupon Bond". As per this definition, 'zero coupon bond' means a bond issued by any infrastructure capital company or infrastructure capital fund or a public sector company *or a scheduled bank* on or after 1st June, 2005, in respect of which no payment and benefit is received or receivable before maturity or redemption from such issuing entity and which the Central Government may notify in this behalf. Accordingly, the Central Government has specified the following bonds to be issued on or before 31.3.2009 as zero coupon bonds –

(i) 10 year zero coupon bonds of HUDCO, SIDBI, NABARD and IDFC;

(ii) 15 year zero coupon bonds of HUDCO;

(iii) 15 year zero coupon bonds of Power Finance Corporation; and

(iv) 10 year zero coupon bonds of National Housing Bank.

The income on transfer of a ZCB (not being held as stock-in-trade) is to be treated as capital gains. Section 2(47)(iva) provides that maturity or redemption of a ZCB shall be treated as a transfer for the purposes of capital gains tax. ZCBs held for not more than 12 months would be treated as short term capital assets. Where the period of holding of ZCBs is more than 12 months, the resultant long term capital gains arising on maturity or redemption would be treated in the same manner as applicable to capital gains arising from the transfer of other listed securities or units covered by section 112. Thus, where the tax payable in respect of any income arising from transfer of ZCBs exceeds 10% of the amount of capital gains before giving effect to the provisions of the second proviso to section 48 on indexation, then, such excess shall be ignored for the purpose of computing the tax payable.

The terms "infrastructure capital company" and "infrastructure capital fund" have been defined in section 2(26A) and 2(26B), respectively. For details, refer Chapter 1- Basic Concepts.

7.3 SHORT-TERM AND LONG-TERM CAPITAL ASSETS

Section 2(42A) defines short-term capital asset as a capital asset held by an assessee for not more than 36 months immediately preceding the date of its transfer. Therefore, a capital asset held by an assessee for more than 36 months immediately preceding the date of its

transfer is a long-term capital asset.

However, in the case of company shares, various securities listed in a recognised Stock Exchange in India, units of the Unit Trust of India and of Mutual Funds specified under section 10(23D) or a Zero Coupon Bond, the said assets will be considered as long-term capital assets if they are held for more than 12 months. Further, in the case of a capital asset being a share or any other security or a right to subscribe to any share or security where such right is renounced in favour of any other person, the period shall be calculated for treating the capital asset as a short-term capital asset from the date of allotment of such share or security or from the date of offer of such right by the company or institution concerned.

Security - This term has the same meaning assigned to it in section 2(b) of Securities Contracts (Regulation) Act, 1956.

Determination of period of holding - The following points must be noted in this regard:

(i) In the case of a share held in a company in liquidation, the period subsequent to the date on which the company goes into liquidation should be excluded.

(ii) Section 49(1) specifies some special circumstances under which capital asset becomes the property of an assessee. For example, an assessee may get a capital asset on a distribution of assets on the partition of a HUF or he may get a gift or he may get the property under a will or from succession, inheritance etc. In such cases, the period for which the asset was held by the previous owner should be taken into account.

(iii) In the case of shares held in an amalgamated company in lieu of shares in the amalgamating company, the period will be counted from the date of acquisition of shares in the amalgamating company.

(iv) In the case of a capital asset being a share or any other security or a right to subscribe to any share or security where such right is renounced in favour of any other person, the period shall be calculated from the date of allotment of such share or security or from the date of offer of such right by the company or institution concerned.

(v) In respect of other capital assets, the period for which any capital asset is held by the assessee shall be determined in accordance with any rules made by the CBDT in this behalf.

(vi) In the case of a capital asset, being a financial asset, allotted without any payment and on the basis of holding of any other financial asset the period shall be reckoned from the date of the allotment of such financial asset.

(vii) In the case of a capital asset being shares in an Indian company, which becomes the property of the assessee in consideration of a demerger, the period of holding shall include the period for which the shares were held in the demerged company by the assessee.

(viii) In the case of a capital asset being equity shares, or trading or clearing rights, of a stock exchange acquired by a person pursuant to demutualization or corporatisation of a recognised stock exchange in India as referred to in clause (xiii) of section 47, there shall be included while calculating the period of holding of such assets the period, for which the person was a member of the recognised stock exchange immediately prior to such demutualization or corporatisation.

(ix) In the case of a capital asset, being any specified security or sweat equity shares allotted or transferred, directly or indirectly, by the employer free of cost or at concessional rate to his employees (including former employee or employees), the period shall be reckoned from the date of allotment or transfer of such specified security or sweat equity shares.

Specified security" means the securities as defined in section 2(h) of the Securities Contracts (Regulation) Act, 1956 and, where employees' stock option has been granted under any plan or scheme therefor, includes the securities offered under such plan or scheme.

"Sweat equity shares" means equity shares issued by a company to its employees or directors at a discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called.

In respect of capital assets other than those listed above, the period of holding shall be determined subject to any rules which the Board may make in this behalf.

7.4 TRANSFER: WHAT IT MEANS [SECTION 2(47)]

The Act contains an inclusive definition of the term 'transfer'. Accordingly, transfer in relation to a capital asset includes the following types of transactions :—

(i) the sale, exchange or relinquishment of the asset; or

(ii) the extinguishment of any rights therein; or

(iii) the compulsory acquisition thereof under any law; or

(iv) the owner of a capital asset may convert the same into the stock-in-trade of a business carried on by him. Such conversion is treated as transfer; or

(v) the maturity or redemption of a Zero Coupon Bond; or

(vi) Part-performance of the contract : Sometimes, possession of an immovable property is given in consideration of part-performance of a contract. For example, A enters into an agreement for the sale of his house. The purchaser gives the entire sale consideration to A. A hands over complete rights of possession to the purchaser since he has realised the entire sale consideration. Under Income-tax Act, the above transaction is considered as transfer; or

(vii) Lastly, there are certain types of transactions which have the effect of transferring or enabling the enjoyment of an immovable property. For example, a person may become a member of a co-operative society, company or other association of persons which may be building houses/flats. When he pays an agreed amount, the society etc. hands over possession of the house to the person concerned. No conveyance is registered. For the purpose of income-tax, the above transaction is a transfer. Even power of attorney transactions are covered.

7.6 Income Tax

7.5 SCOPE AND YEAR OF CHARGEABILITY [SECTION 45]

(i) General Provision [Section 45(1)] - Any profits or gains arising from the transfer of a capital asset effected in the previous year (other than exemptions covered under this chapter) shall be chargeable to Income-tax under this head in the previous year in which the transfer took place.

(ii) Receipts from insurance parties [Section 45(1A)] - Where any person receives any money or other assets under any insurance from an insurer on account of damage to or destruction of any capital asset, as a result of flood, typhoon, hurricane, cyclone, earthquake or other convulsion of nature, riot or civil disturbance, accidental fire or explosion or because of action by an enemy or action taken in combating an enemy (whether with or without declaration of war), then, any profits or gains arising from receipt of such money or other assets shall be chargeable to income-tax under the head "Capital gains" and shall be deemed to be the income of the such person for the previous year in which money or other asset was received.

For the purposes of section 48, the value of any money or the fair market value of other assets on the date of such receipt shall be deemed to be the full value of the consideration received or accruing as a result of the transfer of such capital assets.

(iii) Conversion or treatment of a capital asset as stock-in-trade [Section 45(2)]

A person who is the owner of a capital asset may convert the same or treat it as stock-in-trade of the business carried on by him. As noted above, the above transaction is a transfer. As per section 45(2), the profits or gains arising from the above conversion or treatment will be chargeable to income-tax as his income of the previous year in which such stock-in-trade is sold or otherwise transferred by him. In order to compute the capital gains, the fair market value of the asset on the date of such conversion or treatment shall be deemed to be the full value of the consideration received as a result of the transfer of the capital asset.

Illustration 1

A is the owner of a car. On 1-4-2009, he starts a business of purchase and sale of motor cars. He treats the above car as part of the stock-in-trade of his new business. He sells the same on 31-3-2010 and gets a profit of Rs.1 lakh. Discuss the tax implication.

Solution

Since car is a personal asset, conversion or treatment of the same as the stock-in-trade of his business will not be trapped by the provisions of section 45(2). Hence A is not liable to capital gains tax.

Illustration 2

X converts his capital asset (acquired on June 10, 1988 for Rs.60,000) into stock-in-trade in March 10, 2008. The fair market value on the date of the above conversion was

Rs.2,20,000. He subsequently sells the stock-in-trade so converted for Rs.2,50,000 on June 10, 2009. Discuss the tax implication.

Solution

Since the capital asset is converted into stock-in-trade during the previous year relevant to the A.Y. 2008-09, it will be a transfer under section 2(47) during the P.Y.2007-08. However, the profits or gains arising from the above conversion will be chargeable to tax during the A.Y. 2010-11, since the stock-in-trade has been sold only on June 10, 2009. For this purpose, the fair market value on the date of such conversion (i.e. 10th March, 2008) will be the full value of consideration.

The capital gains will be computed after deducting the indexed cost of acquisition from the full value of consideration. The cost inflation index for 1988-89 *i.e.,* the year of acquisition is 161 and the index for the year of transfer *i.e.,* 2007-08 is 551. The indexed cost of acquisition is 60,000 × 551/161 = Rs.2,05,342. Hence, Rs.14,658 (i.e. Rs.2,20,000 – Rs.2,05,342) will be treated as long-term capital gains chargeable to tax during the A.Y.2010-11. During the same assessment year, Rs.30,000 (Rs.2,50,000 - Rs.2,20,000) will be chargeable to tax as business profits.

Year of chargeability - Capital gains are chargeable as the income of the previous year in which the sale or transfer takes place. In other words, for determining the year of chargeability, the relevant date of transfer is not the date of the agreement to sell, but the actual date of sale *i.e.,* the date on which the effect of transfer of title to the property as contemplated by the parties has taken place [*Alapati Venkatramiah* v. *CIT* [1965] 57 ITR 185 (SC)]. Thus, in the case of any immovable property of the value exceeding Rs. 100, the title to the property cannot pass from the transferor to the transferee until and unless a deed of conveyance is executed and registered. Mere delivery of possession of the immovable property could not itself be treated as equivalent to conveyance of the immovable property. In the case of any movable property, the title to which would pass immediately on delivery of the property in accordance with the agreement to sell, the transfer will be complete on such delivery. However, as already noted, Income-tax Act has recognised certain transactions as transfer in spite of the fact that conveyance deed might not have been executed and registered. Power of Attorney sales as explained above or co-operative society transactions for acquisition of house are examples in this regard.

(iv) Transfer of beneficial interest in securities [Section 45(2A)]

As per section 45(2A), where any person has had at any time during the previous year any beneficial interest in any securities, then, any profits or gains arising from the transfer made by the Depository or participant of such beneficial interest in respect of securities shall be chargeable to tax as the income of the beneficial owner of the previous year in which such transfer took place and shall not be regarded as income of the depository who is deemed to be the registered owner of the securities by virtue of sub-section (1) of section 10 of the Depositories Act, 1996. For the purposes of section 48 and proviso to

section 2(42A), the cost of acquisition and the period of holding of securities shall be determined on the basis of the first-in-first-out (FIFO) method.

When the securities are transacted through stock exchanges it is the established procedure that the brokers first enter into contracts for purchase/sale of securities and thereafter, follow it up with delivery of shares, accompanied by transfer deeds duly signed by the registered holders. The seller is entitled to receive the consideration agreed to as on the date of contract. Thus, it is the date of broker's note that should be treated as the date of transfer in case of sale transactions of securities provided such transactions are followed up by delivery of shares and also the transfer deeds. Similarly, in respect of the purchasers of the securities, the holding period shall be reckoned to take place directly between the parties and not through stock exchanges. The date of contract of sale as declared by the parties shall be treated as the date of transfer provided it is followed up by actual delivery of shares and the transfer deeds.

Where securities are acquired in several lots at different points of time, the First-In-First-Out (FIFO) method shall be adopted to reckon the period of the holding of the security, in cases where the dates of purchase and sale could not be correlated through specific numbers of the scrips. In other words, the assets acquired last will be taken to be remaining with the assessee while assets acquired first will be treated as sold. Indexation, wherever applicable, for long-term assets will be regulated on the basis of the holding period determined in this manner - *CBDT Circular No. 704, dated 28.4.1995.*

“Beneficial owner” means a person whose name is recorded as such with a depository.

“Depository” means a company formed and registered under the Companies Act, 1956 and which has been granted a certificate of registration under sub-section (1A) of section 12 of the Securities and Exchange Board of India Act, 1992.

“Security” means such security as may be specified by SEBI.

(v) Introduction of capital asset as capital contribution [Section 45(3)]

Where a person transfers a capital asset to a firm, AOP or BOI in which he is already a partner/member or is to become a partner/member by way of capital contribution or otherwise, the profits or gains arising from such transfer will be chargeable to tax as income of the previous year in which such transfer takes place. For this purpose, the value of the consideration will be the amount recorded in the books of account of the firm, AOP or BOI as the value of the capital asset.

Illustration 3

A is the owner of a foreign car. He starts a firm in which he and his two sons are partners. As his capital contribution, he transfers the above car to the firm. The car had cost him Rs.2,00,000. The same is being introduced in the firm at a recorded value of Rs.3,50,000. Discuss.

Solution

Car is not capital asset but is a personal effect. Section 45(3), as explained above, covers only cases of transfer of capital asset as contribution and not personal effects. Hence, the above transaction will not be subject to capital gains tax.

(vi) Distribution of capital assets on a firm's dissolution [Section 45(4)]

The profits or gains arising from the transfer of capital assets by way of distribution of capital assets on the dissolution of a firm or AOP or BOI or otherwise shall be chargeable to tax as the income of the firm etc. of the previous year in which such transfer takes place. For this purpose, the fair market value of the asset on the date of such transfer shall be the full value of consideration.

The Bombay High Court made a landmark judgment in *Commissioner of Income-tax v. A.N. Naik Associates (2004) 136 Taxman 107.* The Court applied the "mischief rule" about interpretation of statutes and pointed out that the idea behind the introduction of sub-section (4) in section 45 was to plug in a loophole and block the escape route through the medium of the firm. The High Court observed that the expression 'otherwise' has not to be read *ejusdem generis* with the expression 'dissolution of a firm or body of individuals or association of persons'. The expression 'otherwise' has to be read with the words 'transfer of capital assets by way of distribution of capital assets'. If so read, it becomes clear that even when a firm is in existence and there is a transfer of capital asset, it comes within the expression 'otherwise' since the object of the amendment was to remove the loophole which existed, whereby capital gains tax was not chargeable. Therefore, the word 'otherwise' takes into its sweep not only cases of dissolution but also cases of subsisting partners of a partnership, transferring assets in favour of retiring partners.

(vii) Compensation on compulsory acquisition [Section 45(5)]

Sometimes, a building or some other capital asset belonging to a person is taken over by the Central Government by way of compulsory acquisition. In that case, the consideration for the transfer is determined by the Central Government. When the Central Government pays the above compensation, capital gains may arise. Such capital gains are chargeable as income of the previous year in which such compensation is received.

Enhanced Compensation - Many times, persons whose capital assets have been taken over by the Central Government and who get compensation from the government go to the court of law for enhancement of compensation. If the court awards a compensation which is higher than the original compensation, the difference thereof will be chargeable to capital gains in the year in which the same is received from the government. For this purpose, the cost of acquisition and cost of improvement shall be taken to be *nil*.

Reduction of enhanced compensation **-** Where capital gain has been charged on the compensation received by the assessee for the compulsory acquisition of any capital

asset or enhanced compensation received by the assessee and subsequently such compensation is reduced by any court, tribunal or any authority, the assessed capital gain of that year shall be recomputed by taking into consideration the reduced amount. This re-computation shall be done by way of rectification under section 155.

Death of the transferor - It is possible that the transferor may die before he receives the enhanced compensation. In that case, the enhanced compensation or consideration will be chargeable to tax in the hands of the person who received the same.

(viii) Repurchase of mutual fund units referred to in section 80CCB [Section 45(6)] - The difference between the repurchase price and the amount invested will be chargeable to tax in the previous year in which such repurchase takes place or the plan referred to in section 80CCB is terminated.

Note - *Since the tax treatment accorded to a LLP and a general partnership is the same, the conversion from a general partnership firm to an LLP will have no tax implications if the rights and obligations of the partners remain the same after conversion and if there is no transfer of any asset or liability after conversion. However, if there is a change in rights and obligations of partners or there is a transfer of asset or liability after conversion, then the provisions of section 45 would get attracted.*

7.6 CAPITAL GAINS ON DISTRIBUTION OF ASSETS BY COMPANIES IN LIQUIDATION [SECTION 46]

(1) Where the assets of a company are distributed to its shareholders on its liquidation, such distribution shall not be regarded as a transfer by the company for the purposes of section 45 [Section 46(1)]. The above section is restricted in its application to the circumstances mentioned therein *i.e.,* the assets of the company must be distributed in specie to shareholders on the liquidation of the company. If, however, the liquidator sells the assets of the company resulting in a capital gain and distributes the funds so collected, the company will be liable to pay tax on such gains.

(2) Shareholders receive money or other assets from the company on its liquidation. They will be chargeable to income-tax under the head 'capital gains' in respect of the market value of the assets received on the date of distribution, or the moneys so received by them. The portion of the distribution which is attributable to the accumulated profits of the company is to be treated as dividend income of the shareholder under section 2(22)(*c*). The same will be deducted from the amount received/fair market value for the purpose of determining the consideration for computation of capital gains.

(3) Capital gains tax on subsequent sale by the shareholders - If the shareholder, after receipt of any such asset on liquidation of the company, transfers it within the meaning of section 45 at a price which is in excess of his cost of acquisition determined in the manner aforesaid, such excess becomes taxable in his hands under section 45.

7.7 CAPITAL GAINS ON BUYBACK, ETC. OF SHARES [SECTION 46A]

Any consideration received by a shareholder or a holder of other specified securities from any company on purchase of its own shares or other specified securities held by such shareholder or holder of other specified securities shall be chargeable to tax on the difference between the cost of acquisition and the value of consideration received by the holder of securities or by the shareholder, as the case may be, as capital gains. The computation of capital gains shall be made in accordance with the provisions of section 48.

Such capital gains shall be chargeable in the year in which such shares/securities were purchased by the company. For this purpose, "specified securities" shall have the same meaning as given in Explanation to section 77A of the Companies Act, 1956.

7.8 TRANSACTIONS NOT REGARDED AS TRANSFER [SECTION 47]

Section 47 specifies certain transactions which will not be regarded as transfer for the purpose of capital gains tax:

(1) Any distribution of capital assets on the total or partial partition of a HUF;

(2) Any transfer of a capital asset under a gift or will or an irrevocable trust;

However, this clause shall not include transfer under a gift or an irrevocable trust of a capital asset being shares, debentures or warrants allotted by a company directly or indirectly to its employees under the Employees' Stock Option Plan or Scheme offered to its employees in accordance with the guideliness issued in this behalf by the Central Government.

(3) Any transfer of a capital asset by a company to its subsidiary company.

Conditions -(i) The parent company must hold the whole of the shares of the subsidiary company; (ii) The subsidiary company must be an Indian company.

(4) Any transfer of capital asset by a subsidiary company to a holding company;

Conditions - (i) The whole of shares of the subsidiary company must be held by the holding company; (ii) The holding company must be an Indian company.

Exception - The exemption mentioned in 3 or 4 above will not apply if a capital asset is transferred as stock-in-trade.

(5) Any transfer in a scheme of amalgamation of a capital asset by the amalgamating company to the amalgamated company if the amalgamated company is an Indian company.

(6) Any transfer in a scheme of amalgamation of shares held in an Indian company by the amalgamating foreign company to the amalgamated foreign company.

Conditions -(i) At least 25 percent of the shareholders of the amalgamating foreign

company must continue to remain shareholders of the amalgamated foreign company; (ii) Such transfer should not attract capital gains in the country in which the amalgamating company is incorporated.

(7) Any transfer, in a scheme of amalgamation of a banking company with a banking institution sanctioned and brought into force by the Central Government under section 45(7) of the Banking Regulation Act, 1949, of a capital asset by such banking company to such banking institution.

*(*8) Any transfer by a shareholder in a scheme of amalgamation of shares held by him in the amalgamating company.

Conditions - (i) The transfer is made in consideration of the allotment of any share in the amalgamated company to him; (ii) The amalgamated company is an Indian company.

Illustration 4

M held 2000 shares in a company ABC Ltd. This company amalgamated with another company during the previous year ending 31-3-2010. Under the scheme of amalgamation, M was allotted 1000 shares in the new company. The market value of shares allotted is higher by Rs.50,000 than the value of holding in ABC Ltd. The Assessing Officer proposes to treat the transaction as an exchange and to tax Rs.50,000 as capital gain. Is he justified?

Solution

In the above example, assuming that the amalgamated company is an Indian company, the transaction is squarely covered by the exemption explained above and the proposal of the Assessing Officer to treat the transaction as an exchange is not justified.

(9) Any transfer in a demerger, of a capital asset by the demerged company to the resulting company, if the resulting company is an Indian company.

(10) Any transfer in a demerger, of a capital asset, being a share or shares held in an Indian company, by the demerger foreign company to the resulting foreign company.

Conditions - (i) The shareholders holding at least three-fourths in value of the shares of the demerged foreign company continue to remain shareholders of the resulting foreign company; and

(ii) Such transfer does not attract tax on capital gains in the country, in which the demerged foreign company is incorporated.

However, the provisions of sections 391 to 394 of the Companies Act, 1956, shall not apply in case of demergers referred to in this clause.

*(*11) any transfer in a business reorganisation, of a capital asset by the predecessor co-operative bank to the successor co-operative bank.

(12) any transfer by a shareholder, in a business reorganisation, of a capital asset being a share or shares held by him in the predecessor co-operative bank if the transfer is made in consideration of the allotment to him of any share or shares in the successor co-operative bank.

Note – Refer to section 44DDB for the meanings of "business reorganisation", "predecessor co-operative bank" and "successor co-operative bank".

(13) Any transfer or issue of shares by the resulting company, in a scheme of demerger to the shareholders of the demerged company if the transfer or issue is made in consideration of demerger of the undertaking.

(14) Any transfer of bonds or shares referred to in section 115AC(1).

Conditions - (*i*) The transfer must be made outside India; (*ii*) The transfer must be made by the non-resident to another non-resident.

(15) Any transfer of agricultural lands effected before 1-3-1970.

(16) Any transfer of any of the following capital asset to the government or to the University or the National Museum, National Art Gallery, National Archives or any other public museum or institution notified by the Central Government to be of (national importance or to be of) renown throughout any State :

(i) work of art

(ii) archaeological, scientific or art collection

(iii) book

(iv) manuscript

(v) drawings

(vi) paintings

(vii) photographs

(viii) printings.

(17) Any transfer by way of conversion of bonds or debentures, debenture stock or deposit certificates in any form, of a company into shares or debentures of that company.

(18) Any transfer by way of conversion of Foreign Currency Exchangeable Bonds into shares or debentures of a company.

(19) Transfer by way of exchange of a capital asset being membership of a recognised stock exchange for shares of a company to which such membership is transferred.

Conditions - (*i*) Such exchange is effected on or before 31st December, 1998 and (*ii*) such shares are retained by the transferor for a period of not less than three years from the date of transfer.

7.14 Income Tax

(20) Capital gains arising from the transfer of land under a scheme prepared and sanctioned under section 18 of the Sick Industrial Companies (Special Provisions) Act, 1985, by a sick industrial company which is managed by its workers' co-operative.

Conditions - Such transfer is made in the period commencing from the previous year in which the said company has become a sick industrial company and ending with the previous year during which the entire net worth of such company becomes equal to or exceeds the accumulated losses.

(21) Where a firm is succeeded by a company or where an AOP or BOI is succeeded by a company in the course of demutualisation or corporatisation of a recognised stock exchange in India, any transfer of a capital asset or intangible asset (in the case of a firm).

Conditions - (i) All assets and liabilities of the firm or AOP or BOI relating to the business immediately before the succession become the assets and liabilities of the company;

(ii) All the partners of the firm immediately before the succession become the shareholders of the company and the proportion in which their capital accounts stood in the books of the firm on the date of succession remains the same;

(iii) The partners of the firm do not receive any consideration or benefit in any form, directly or indirectly, other than by way of allotment of shares in the company.

(iv) The partners of the firm together hold not less than 50% of the total voting power in the company, and their shareholding continues in such manner for a period of 5 years from the date of succession.

(v) The corporatisation of a recognised stock exchange in India is carried out in accordance with a scheme for demutualisation or corporatisation approved by SEBI.

(22) any transfer of a membership right by a member of recognised stock exchange in India for acquisition of shares and trading or clearing rights in accordance with a scheme for demutualization or corporatisation approved by SEBI.

(23) Where a sole proprietary concern is succeeded by a company in the business carried out by it, as a result of which the sole proprietary concern transfers or sells any capital asset or intangible asset to such company.

Conditions - (i) All assets and liabilities of the sole proprietary concern relating to the business immediately before the succession become the assets and liabilities of the company;

(ii) The sole proprietor holds not less than 50% of the total voting power in the company, and his shareholding continues in such manner for a period of 5 years from the date of succession;

(iii) The sole proprietor does not receive any consideration or benefit in any form, directly or indirectly, other than by way of allotment of shares in the company.

(24) Any transfer in a scheme for lending of any securities under an agreement or arrangement which the assessee has entered into with the borrower of such securities and which is subject to the guidelines issued by SEBI or the RBI.

(25) Any transfer of a capital asset in a scheme of reverse mortgage under a scheme made and notified by the Central Government.

Illustration 5

In which of the following situations capital gains tax liability does not arise?

(i) Mr. A purchased gold in 1970 for Rs.25,000. In 2009-10, he gifted it to his son at the time of marriage. Fair market value (FMV) of the gold on the day the gift was made was Rs.1,00,000.

(ii) A house property is purchased by a Hindu undivided family in 1945 for Rs.20,000. It is given to one of the family members in 2009-2010 at the time of partition of the family. FMV on the day of partition was Rs.12,00,000.

(iii) Mr. B purchased 50 convertible debentures for Rs.40,000 in 1995 which are converted in to 500 shares worth Rs.85,000 in November 2009 by the company.

Solution

We know that capital gains arise only when we transfer a capital asset. The liability of capital gains tax in the situations given above is discussed as follows:

(i) As per the provisions of section 47(iii), transfer of a capital asset under a gift is not regarded as transfer for the purpose of capital gains. Therefore, capital gains tax liability does not arise in the given situation.

(ii) As per the provisions of section 47(i), transfer of a capital asset (being in kind) on the total or partial partition of Hindu undivided family is not regarded as transfer for the purpose of capital gains. Therefore, capital gains tax liability does not arise in the given situation.

(iii) As per the provisions of section 47(x), transfer by way of conversion of bonds or debentures, debenture stock or deposit certificates in any form of a company into shares or debentures of that company is not regarded as transfer for the purpose of capital gains. Therefore, capital gains tax liability does not arise in the given situation.

7.9 IMPORTANT DEFINITIONS

(a) Amalgamation [Section 2(1B)] - "Amalgamation", in relation to companies, means the merger of one or more companies with another company or the merger of two or more companies to form one company (the company or companies which so merge being referred to as the amalgamating company or companies and the company with which they merge or which is formed as a result of the merger, as the amalgamated company) in such a manner that -

7.16 Income Tax

(i) all the property of the amalgamating company or companies immediately before the amalgamation becomes the property of the amalgamated company by virtue of the amalgamation;

(ii) all the liabilities of the amalgamating company or companies immediately before the amalgamation become the liabilities of the amalgamated company by virtue of the amalgamation;

(iii) shareholders holding not less than three-fourth in value of the shares in the amalgamating company or companies (other than shares already held therein immediately before the amalgamation by, or by a nominee for, the amalgamated company or its subsidiary) become shareholders of the amalgamated company by virtue of the amalgamation, otherwise than as a result of the acquisition of the property of one company by another company pursuant to the purchase of such property by the other company or as a result of the distribution of such property to the other company after the winding up of the first mentioned company.

(b) Demerger [Section 2(19AA)] - "Demerger", in relation to companies, means the transfer, pursuant to a scheme of arrangement under sections 391 to 394 of the Companies Act, 1956, by a demerged company of its one or more undertaking to any resulting company in such a manner that -

(i) all the property of the undertaking, being transferred by the demerged company, immediately before the demerger, becomes the property of the resulting company by virtue of the demerger;

(ii) all the liabilities relatable to the undertaking, being transferred by the demerged company, immediately before the demerger, become the liabilities of the resulting company by virtue of the demerger;

(iii) the property and the liabilities of the undertaking or undertakings being transferred by the demerged company are transferred at values appearing in its books of account immediately before the demerger;

(iv) the resulting company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis;

(v) the shareholders holding not less than three-fourths in value of the shares in the demerged company (other than shares already held therein immediately before the demerger, or by a nominee for, the resulting company or, its subsidiary) become shareholders of the resulting company or companies by virtue of the demerger, otherwise than as a result of the acquisition of the property or assets of the demerged company or any undertaking thereof by the resulting company;

(vi) the transfer of the undertaking is on a going concern basis;

(vii) the demerger is in accordance with the conditions, if any, notified under sub-section (5) of section 72A by the Central Government in this behalf.

Explanation 1 - For the purposes of this clause, "undertaking" shall include any part of an undertaking, or a unit or division of an undertaking or a business activity taken as a whole, but does not include individual assets or liabilities or any combination thereof not constituting a business activity.

Explanation 2 - For the purposes of this clause, the liabilities referred to in sub-section (ii), shall include-

(a) the liabilities which arise out of the activities or operations of the undertaking;

(b) the specific loans or borrowings (including debentures) raised, incurred and utilised solely for the activities or operations of the undertaking; and

(c) in cases, other than those referred to in clause (a) or clause (b), so much of the amounts of general or multipurpose borrowings, if any, of the demerged company as stand in the same proportion which the value of the assets transferred in a demerger bears to the total value of the assets of such demerged company immediately before the demerger.

Explanation 3 - For determining the value of the property referred to in sub-clause (*iii*), any change in the value of assets consequent to their revaluation shall be ignored.

Explanation 4 - For the purposes of this clause, the splitting up or the reconstruction of any authority or a body constituted or established under a Central, State or Provincial Act, or a local authority or a public sector company, into separate authorities or bodies or local authorities or companies, as the case may be, shall be deemed to be a demerger if such split up or reconstruction fulfils such conditions as may be notified by the Central Government in the Official Gazette.

"Demerged company" means the company whose undertaking is transferred, pursuant to a demerger, to a resulting company.

7.10 WITHDRAWAL OF EXEMPTION IN CERTAIN CASES

Section 47A provides for withdrawal of the benefit of exemption given by section 47 in certain cases.

As noted above, capital gains arising from the transfer of a capital asset by a company to its wholly owned subsidiary company is exempt from tax. Similarly, capital gains arising from the transfer of a capital asset by the subsidiary company to the holding company is also exempt from tax, provided under both circumstances the transferee is an Indian company.

Section 47A provides that the above exemption will be withdrawn in the following cases:

(1) Where at any time before the expiry of eight years from the date of transfer of a capital asset referred to above, such capital asset is converted by the transferee company

or is treated by it as stock-in-trade of its business;

(2) Where before eight years as noted above, the parent company or its nominee ceases to hold the whole of the share capital of the subsidiary company.

In the above two cases, the amount of capital gains exempt from tax by virtue of the provisions contained in section 47 will be deemed to be the income of the transferor company chargeable under the head 'capital gains' of the year in which such transfer took place.

(3) Capital gains not charged to tax under clause (xi) of section 47 shall be deemed to be the income chargeable under the head "capital gains" of the previous year in which such transfer took place if the shares of the company received in exchange for transfer of membership in a recognised stock exchange are transferred at any time before the expiry of three years of such transfer.

(4) Where any of the conditions laid down in section 47 for succession of a firm or sole proprietary concern by a company are not complied with, the amount of profits or gains arising from the transfer of such capital asset or intangible asset shall be deemed to be the profits and gains chargeable to tax of the successor company for the previous year in which the conditions are not complied with.

7.11 MODE OF COMPUTATION OF CAPITAL GAINS

(i) The income chargeable under the head 'capital gains' shall be computed by deducting the following items from the full value of the consideration received or accruing as a result of the transfer of the capital asset:

(1) Expenditure incurred wholly and exclusively in connection with such transfer.

(2) The indexed cost of acquisition and indexed cost of any improvement thereto.

(ii) However, no deduction shall be allowed in computing the income chargeable under the head "Capital Gains" in respect of any amount paid on account of securities transaction tax under Chapter VII of the Finance (No.2) Act, 2004.

Under section 48, the cost of acquisition will be increased by applying the cost inflation index (CII). Once the cost inflation index is applied to the cost of acquisition, it becomes indexed cost of acquisition. This means an amount which bears to the cost of acquisition, the same proportion as CII for the year in which the asset is transferred bears to the CII for the first year in which the asset was held by the assessee or for the year beginning on 1st April, 1981, whichever is later. Similarly, indexed cost of any improvement means an amount which bears to the cost of improvement, the same proportion as CII for the year in which the asset is transferred bears to the CII for the year in which the improvement to the asset took place. CII for any year means such index as the Central Government may, having regard to 75% of the average rise in the consumer price index for urban non-

manual employees for the immediately preceding previous year to that year by notification in the Official Gazette, specify in this behalf.

Note - The benefit of indexation will not apply to the long-term capital gains arising from the transfer of bonds or debentures other than capital indexed bonds issued by the Government.

In case of depreciable assets (discussed later), there will be no indexation or the capital gains will always be short-term capital gains.

(iii) Cost Inflation Index

The cost inflation indices for the financial years so far have been notified as under:

Financial Year	Cost Inflation Index	Financial Year	Cost Inflation 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		

As noted above, for the financial year 1981-82, CII is 100 and the CII for each subsequent year would be determined in such a way that 75% of the rise in consumer price index for urban non-manual employees would be reflected in the rise in CII. It would be seen that the date of transfer of an asset would be immaterial as long as it is within a particular financial year. That means, transfer of assets in any part of the year would be subject to indexation using the same CII as applicable to an asset transferred on 1st April of the year. The effect is that all the assets transferred during the year will be deemed to be sold on the first day of the year.

(iv) Special provision for non-residents

In order to give protection to non-residents who invest foreign exchange to acquire capital

assets, section 48 contains a proviso. Accordingly, in the case of non-residents, capital gains arising from the transfer of shares or debentures of an Indian company is to be computed as follows:

The cost of acquisition, the expenditure incurred wholly and exclusively in connection with the transfer and the full value of the consideration are to be converted into the same foreign currency with which such shares were acquired. The resulting capital gains shall be reconverted into Indian currency. The aforesaid manner of computation of capital gains shall be applied for every purchase and sale of shares or debentures in an Indian company. Rule 115A is relevant for this purpose.

7.12 ASCERTAINMENT OF COST IN SPECIFIED CIRCUMSTANCES [SECTION 49]

A person becomes the owner of a capital asset not only by purchase but also by several other methods. Section 49 gives guidelines as to how to compute the cost under different circumstances.

(1) In the following cases, the cost of acquisition of the asset shall be deemed to be cost for which the previous owner of the property acquired it. To this cost, the cost of improvement to the asset incurred by the previous owner or the assessee must be added:

Where the capital asset became the property of the assessee:

(i) on any distribution of assets on the total or partition of a HUF;

(ii) under a gift or will;

(iii) by succession, inheritance or devaluation;

(iv) on any distribution of assets on the liquidation of a company;

(v) under a transfer to revocable or an irrevocable trust;

(vi) under any transfer by a holding company to its 100% subsidiary Indian company or vice versa;

(vii) under any scheme of amalgamation by the amalgamating company to the amalgamated Indian company;

(viii) by transfer of shares held in an Indian company in a scheme of amalgamation by the amalgamating foreign company to the amalgamated foreign company;

(ix) by transfer of capital asset by a banking company to a banking institution in a scheme of amalgamation of the banking company with the banking institution.

(x) under any such transfer of a capital asset in a business reorganization by the predecessor co-operative bank to the successor co-operative bank.

(xi) under any such transfer by a shareholder in a business reorganisation, of a capital asset being a share or shares held by him in the predecessor co-operative bank if the transfer is made in consideration of the allotment to him of any share or shares in the successor co-operative bank.

(xii) by conversion by an individual of his separate property into a HUF property, by the mode referred to in section 64(2).

The cost of acquisition of the asset is the cost for which the previous owner acquired the asset as increased by the cost of any improvement of the assets incurred or borne by the previous owner or the assessee, as the case may be.

(2) Where shares in an amalgamated company which is an Indian company become the property of the assessee in consideration of the transfer of shares held by him in the amalgamating company under a scheme of amalgamation, the cost of acquisition to him of the shares in the amalgamated company shall be taken as the cost of acquisition of the shares in the amalgamating company [Section 49(2)].

This also applies in relation to business reorganization of a co-operative bank as referred to in section 44DB. The cost of acquisition of shares in the amalgamated co-operative bank, which became the property of the assessee by virtue of a transfer as a result of business reorganisation shall be the cost of acquisition to him of the shares in the amalgamating co-operative bank.

(3) It is possible that a person might have become the owner of shares or debentures in a company during the process of conversion of bonds or debentures, debenture stock or deposit certificates. In such a case, the cost of acquisition to the person shall be deemed to be that part of the cost of debentures, debenture stock, bond or deposit certificate in relation to which such asset is acquired by that person [Section 49(2A)].

(4) Where the capital gain arises from the transfer of specified security or sweat equity shares referred to in section 17(2)(vi), the cost of acquisition of such security or shares shall be the fair market value which has been taken into account for perquisite valuation [Section 49(2AA)].

(5) Where the capital gain arises from the transfer of specified security or sweat equity shares, the cost of acquisition of such security or shares shall be the fair market value which has been taken into account while computing the value of fringe benefits under clause (ba) of sub-section (1) of section 115WC [Section 49(2AB)].

The value of fringe benefits would be the fair market value of the specified security or sweat equity shares on the date on which the option vests with employee as reduced by the amount actually paid by, or recovered from the employee in respect of such security or shares. Fair market value means the value determined in accordance with the method prescribed by the CBDT. This fair market value would be taken as the cost of acquisition of the specified security or sweat equity shares. It may be noted that the amount recovered from the employee is not to be deducted for determining the cost of acquisition.

***Note** – It may be noted that fringe benefit tax is not applicable from A.Y.2010-11 and therefore, the fair market value of the specified securities and sweat equity shares would be taxed as a perquisite in the hands of the employees w.e.f. A.Y.2010-11. Therefore, if specified securities or sweat equity shares have been subject to FBT in the hands of the employer upto A.Y.2009-10, the provisions of section 49(2AB) would apply for determination*

of the cost of acquisition at the time of transfer. However, if the specified securities or sweat equity shares have been taxed as a perquisite in the hands of the employees w.e.f. A.Y.2010-11, the provisions of section 49(2AA) would apply for determination of the cost of acquisition at the time of transfer of such securities/shares by the employee.

(6) In the case of a demerger, the cost of acquisition of the shares in the resulting company shall be the amount which bears to the cost of acquisition of 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 [Section 49(2C)].

This also applies in relation to business reorganization of a co-operative bank as referred to in section 44DB. The cost of acquisition of the shares in the resulting co-operative bank shall be the amount which bears to the cost of acquisition of shares held by the assessee in the demerged co-operative bank, the same proportion as the net book value of the assets transferred in a demerger bears to the net worth of the demerged co-operative bank immediately before demerger i.e.,

Cost of acquisition of shares in the resulting co-operative bank = $A \times \frac{B}{C}$

A = Cost of acquisition of shares held in the demerged co-operative bank

B = Net book value of the assets transferred in a demerger

C = Net worth of the demerged co-operative bank i.e. the aggregate of the paid up share capital and general reserves as appearing in the books of account of the demerged company immediately before the demerger.

(7) Further, the cost of acquisition of the original shares held by the shareholder in the demerged company shall be deemed to have been reduced by the amount as so arrived under the sub-section (2C) [Section 49(2D)].

This also applies in relation to business reorganization of a co-operative bank as referred to in section 44DB. The cost of acquisition of the original shares held by the shareholder in the demerged co-operative bank shall be deemed to have been reduced by the amount so arrived at in (6) above.

For the above purpose, “net worth” means the aggregate of the paid up share capital and general reserves as appearing in the books of account of the demerged company immediately before the demerger.

Normally speaking, capital gains must be computed after deducting from the sale price the cost of acquisition to the assessee. The various provisions mentioned above form an exception to this general principle.

(8) Where the capital gain arises from the transfer of such property which has been subject to tax under section 56(2)(vii), the cost of acquisition of the property shall be deemed to be the value taken into account for the purposes of section 56(2)(vii). [For illustration, see Unit 5 of Chapter 4 "Income from Other Sources" under section 56(2)(vii)]

7.13 COST OF IMPROVEMENT [SECTION 55]

(1) Goodwill of a business, etc.: In relation to a capital asset being goodwill of a business or a right to manufacture, produce or process any article or thing, or right to carry on any business, the cost of improvement shall be taken to be nil.

(2) Any other capital asset: (i) Where the capital asset became the property of the previous owner or the assessee before 1-4-1981, cost of improvement means all expenditure of a capital nature incurred in making any addition or alteration to the capital asset on or after the said date by the previous owner or the assessee.

(ii) In any other case, cost of improvement means all expenditure of a capital nature incurred in making any additions or alterations to the capital assets by the assessee after it became his property. However, there are cases where the capital asset might become the property of the assessee by any of the modes specified in section 49(1). In that case, cost of improvement means capital expenditure in making any addition or alterations to the capital assets incurred by the previous owner.

However, cost of improvement does not include any expenditure which is deductible in computing the income chargeable under the head "Income from house property", "Profits and gains of business or profession" or "Income from other sources".

Illustration 6

Mr. X & sons, HUF, purchased a land for Rs.40,000 in 1991-92. In 1995-96, a partition takes place when Mr. A, a coparcener, is allotted this plot valued at Rs.80,000. In 1996-97, he had incurred expenses of Rs.1,85,000 towards fencing of the plot. Mr. A sells this plot of land for Rs.15,00,000 in 2009-10 after incurring expenses to the extent of Rs.20,000. You are required to compute the capital gain for the A.Y. 2010-11.

Financial year	Cost Inflation Index
1991-92	199
1995-96	281
1996-97	305
2009-10	632

Solution

Computation of taxable capital gains for the A.Y. 2010-11

Particulars	Rs.	Rs.
Sale consideration		15,00,000
Less: Expenses incurred for transfer		20,000
		14,80,000
Less: (i) Indexed cost of acquisition (40,000 × 632/281)	89,964	
(ii) Indexed cost of improvement (1,85,000 × 632/305)	3,83,344	4,73,308
Long term capital gains		**10,06,692**

Illustration 7

Mr. B purchased convertible debentures for Rs.5,00,000 during August 1998. The debentures were converted into shares in September 2002. These shares were sold for Rs.15,00,000 in August, 2009. The brokerage expenses is Rs.50,000. You are required to compute the capital gains in case of Mr. B for the assessment year 2010-11.

Financial Year	Cost Inflation Index
1998-99	351
2002-03	447
2005-06	497
2009-10	632

Solution

Computation of Capital Gains of Mr. B for the A.Y.2010-11

Particulars	Rs.
Sale consideration	15,00,000
Less: Expenses on transfer i.e. Brokerage paid	50,000
Net consideration	14,50,000
Less: Indexed cost of acquisition (5,00,000 × 632/447)	7,06,935
Long term capital gain	**7,43,065**

Note : For the purpose of computing capital gains, the holding period is considered from the date of allotment of these shares i.e. September 2002 – August 2009.

Illustration 8

Mr. C purchases a house property for Rs.1,06,000 on May 15, 1963. The following

expenses are incurred by him for making addition/alternation to the house property:

		Rs.
a.	Cost of construction of first floor in 1972-73	1,35,000
b.	Cost of construction of the second floor in 1983-84	3,10,000
c.	Reconstruction of the property in 1992-93	2,50,000

Fair market value of the property on April 1, 1981 is Rs.4,50,000. The house property is sold by Mr. C on August 10, 2009 for Rs.60,00,000 (expenses incurred on transfer: Rs.50,000). Compute the capital gain for the assessment year 2010-11.

Financial year	Cost Inflation Index
1981-82	100
1983-84	116
1992-93	223
2009-10	632

Solution

Computation of capital gain of Mr.C for the A.Y.2010-11

Particulars	Rs.	Rs.
Gross sale consideration		60,00,000
Less: Expenses on transfer		50,000
Net sale consideration		59,50,000
Indexed cost of acquisition (Note 1)	28,44,000	
Indexed cost of improvement (Note 2)	23,97,486	52,41,486
Long-term capital gain		7,08,514

Notes:

Indexed cost of acquisition is computed as follows:

Rs.4,50,000 × 632/100 = Rs.28,44,000

Fair market value on April 1, 1981 (actual cost of acquisition is ignored as it is lower than market value on April 1, 1981.)

Indexed cost of improvement is determined as under:	**Rs**.
Construction of first floor in 1972-73	Nil

(expenses incurred prior to April 1, 1981 are not considered)

7.26 Income Tax

Construction of second floor in 1983-84 (i.e., Rs.3,10,000 × 632/116)	16,88,966
Alternation/reconstruction in 1992-93 (i.e., Rs.2,50,000 × 632/223)	7,08,520
Indexed cost of improvement	23,97,486

7.14 COST OF ACQUISITION [SECTION 55]

(i) Goodwill of a business or a trademark or brand name associated with a business or a right to manufacture, produce or process any article or thing, or right to carry on any business, tenancy rights, stage carriage permits and loom hours - In the case of the above capital assets, if the assessee has purchased them from a previous owner, the cost of acquisition means the amount of the purchase price. For example, if A purchases a stage carriage permit from B for Rs.2 lacs, that will be the cost of acquisition for A.

(ii) Self-generated assets - There are circumstances where it is not possible to visualise cost of acquisition. For example, suppose a doctor starts his profession. With the passage of time, the doctor acquires lot of reputation. He opens a clinic and runs it for 5 years. After 5 years he sells the clinic to another doctor for Rs.10 lacs which includes Rs.2 lacs for his reputation or goodwill. Now a question arises as to how to find out the profit in respect of goodwill. It is obvious that the goodwill is self-generated and hence it is difficult to calculate the cost of its acquisition. However, it is certainly a capital asset. The Supreme Court in *CIT* v. *B.C. Srinivasa Shetty [1981] 128 ITR 294 (SC)* held that in order to bring the gains on sale of capital assets to charge under section 45, it is necessary that the provisions dealing with the levy of capital gains tax must be read as a whole. Section 48 deals with the mode of computing the capital gains. Unless the cost of acquisition is correctly ascertainable, it is not possible to apply the provisions of section 48. Self-generated goodwill is such a type of capital asset where it is not possible to visualise cost of acquisition. Once section 48 cannot be applied, the gains thereon cannot be brought to charge.

This decision of the Supreme Court was applicable not only to self-generated goodwill of a business but also to other self-generated assets like tenancy rights, stage carriage permits, loom hours etc. In order to supersede the decision of the Supreme Court cited above, section 55 was amended. Accordingly, in case of self-generated assets namely, goodwill of a business or a trademark or brand name associated with a business or a right to manufacture, produce or process any article or thing, or right to carry on any business, tenancy rights, stage carriage permits, or loom hours, the cost of acquisition will be taken to be *nil*. However, it is significant to note that the above amendment does not cover self-generated goodwill of a profession. So, in respect of self-generated goodwill of a profession and other self-generated assets not specifically covered by the amended provisions of section 55, the decision of the Supreme Court in *B. C. Srinivasa Setty's* case will still apply.

(iii) Other assets - In the following cases, cost of acquisition shall not be *nil*, but will be deemed to be the cost for which the previous owner of the property acquired it:

Where the capital asset became the property of the assessee—

(1) On any distribution of assets on the total or partial partition of a Hindu undivided family.

(2) Under a gift or will.

(3) By succession, inheritance or devolution.

(4) On any distribution of assets on the liquidation of a company.

(5) Under a transfer to a revocable or an irrevocable trust.

(6) Under any such transfer referred to in sections 47(iv), (v), (vi), (via) or (viaa).

(7) Where the assessee is a Hindu undivided family, by the mode referred to in section 64(2).

(iv) Financial assets - Many times persons who own shares or other securities become entitled to subscribe to any additional shares or securities. Further, they are also allotted additional shares or securities without any payment. Such shares or securities are referred to as financial assets in Income-tax Act. Section 55 provides the basis for ascertaining the cost of acquisition of such financial assets.

(1) In relation to the original financial asset on the basis of which the assessee becomes entitled to any additional financial assets, cost of acquisition means the amount actually paid for acquiring the original financial assets.

(2) In relation to any right to renounce the said entitlement to subscribe to the financial asset, when such a right is renounced by the assessee in favour of any person, cost of acquisition shall be taken to be *nil* in the case of such assessee.

(3) In relation to the financial asset, to which the assessee has subscribed on the basis of the said entitlement, cost of acquisition means the amount actually paid by him for acquiring such asset.

(4) In relation to the financial asset allotted to the assessee without any payment and on the basis of holding of any other financial assets, cost of acquisition shall be taken to be nil in the case of such assessee. In other words, where bonus shares are allotted without any payment on the basis of holding of original shares, the cost of such bonus shares will be nil in the hands of the original shareholder. However, in respect of bonus shares allotted before 1.4.81, although the cost of acquisition of the shares is nil, the assessee may opt for the fair market value as on 1.4.81 as the cost of acquisition of such bonus shares.

(5) In the case of any financial asset purchased by the person in whose favour the right to subscribe to such assets has been renounced, cost of acquisition means the aggregate

of the amount of the purchase price paid by him to the person renouncing such right and the amount paid by him to the company or institution for acquiring such financial asset.

(6) In relation to equity shares allotted to a shareholder of a recognised stock exchange in India under a scheme for demutualisation or corporatisation approved by SEBI, the cost of acquisition shall be the cost of acquiring his original membership of the exchange.

(7) The cost of a capital asset, being trading or clearing rights of a recognised stock exchange acquired by a shareholder (who has been allotted equity share or shares under such scheme of demutualisation or corporatisation), shall be deemed to be nil.

(v) Any other capital asset - (1) Where the capital asset become the property of the assessee before 1-4-1981 cost of acquisition means the cost of acquisition of the asset to the assessee or the fair market value of the asset on 1-4-1981 at the option of the assessee.

(2) Where the capital asset became the property of the assessee by any of the modes specified in section 49(1), it is clear that the cost of acquisition to the assessee will be the cost of acquisition to the previous owner. Even in such cases, where the capital asset became the property of the previous owner before 1-4-1981, the assessee has got a right to opt for the fair market value as on 1-4-1981.

(3) Where the capital asset became the property of the assessee on the distribution of the capital assets of a company on its liquidation and the assessee has been assessed to capital gains in respect of that asset under section 46, the cost of acquisition means the fair market value of the asset on the date of distribution.

(4) A share or a stock of a company may become the property of an assessee under the following circumstances :

(a) the consolidation and division of all or any of the share capital of the company into shares of larger amount than its existing shares.

(b) the conversion of any shares of the company into stock,

(c) the re-conversion of any stock of the company into shares,

(d) the sub-division of any of the shares of the company into shares of smaller amount, or

(e) the conversion of one kind of shares of the company into another kind.

In the above circumstances the cost of acquisition to the assessee will mean the cost of acquisition of the asset calculated with reference to the cost of acquisition of the shares or stock from which such asset is derived.

(vi) Where the cost for which the previous owner acquired the property cannot be ascertained, the cost of acquisition to the previous owner means the fair market value on the date on which the capital asset became the property of the previous owner.

Illustration 9

ABC Ltd., converts its capital asset acquired for an amount of Rs.50,000 in June, 1991 into stock-in-trade in the month of November, 2005. The fair market value of the asset on the date of conversion is Rs.2,00,000. The stock-in-trade was sold for an amount of Rs.3,50,000 in the month of December, 2009. What will be the tax treatment?

Financial year	Cost Inflation Index
1991-92	199
2005-06	497
2009-10	632

Solution

The capital gains on the sale of the capital asset converted to stock-in-trade is taxable in the given case as the conversion was done after April 1, 1985. It arises in the year of conversion (i.e. P.Y. 2005-06) but will be taxable only in the year in which the stock-in-trade is sold (i.e. P.Y. 2009-10). Profits from business will also be taxable in the year of sale of the stock-in-trade (i.e. P.Y. 2009-10).

Gross Total Income for the A.Y.2010-11 is calculated as under:

Particulars	Rs	Rs
Profits and Gains from Business or Profession		
Sale proceeds of the stock-in-trade	3,50,000	
Less : Cost of the stock-in-trade (FMV on the date of conversion)	2,00,000	1,50,000
Long Term Capital Gains		
Full value of the consideration (FMV on the date of the conversion)	2,00,000	
Less : Indexed cost of acquisition (50,000 x 497/199)	1,24,874	75,126
Gross Total Income		2,25,126

Note: For the purpose of indexation, the cost inflation index of the year in which the asset is converted into stock-in-trade should be considered.

Illustration 10

Ms.Usha purchases 1,000 equity shares in X Ltd. at a cost of Rs.15 per share (brokerage 1%) in January 1978. She gets 100 bonus shares in August 1980. She again gets 550 bonus shares by virtue of her holding on February 1985. Fair market value of the shares of X Ltd. on April 1, 1981 is Rs.25. In January 2010, she transfers all her shares @ Rs.120 per share (brokerage 2%).

7.30 Income Tax

Compute the capital gains taxable in the hands of Ms. Usha for the assessment year 2010-11 assuming:

(a) X Ltd is an unlisted company and securities transaction tax was not applicable at the time of sale.

(b) X ltd is a listed company and the shares are sold in a recognised stock exchange and securities transaction tax was paid at the time of sale.

Financial year	Cost Inflation Index
1981-82	100
1984-85	125
2009-10	632

Solution

(a) Computation of capital gains for the A.Y. 2010-11.

Particulars	Rs
1000 Original shares	
Sale proceeds (1000 × Rs.120)	1,20,000
Less : Brokerage paid (2% of Rs.1,20,000)	2,400
Net sale consideration	1,17,600
Less : Indexed cost of acquisition [Rs.25 × 1000 × 632/100]	1,58,000
Long term capital loss (A)	40,400
100 Bonus shares	
Sale proceeds (100 × Rs.120)	12,000
Less : Brokerage paid (2% of Rs.12,000)	240
Net sale consideration	11,760
Less : Indexed cost of acquisition [Rs.25 × 100 × 632/100] [note]	15,800
Long term capital loss (B)	4,040
550 Bonus shares	
Sale proceeds (550 × Rs.120)	66,000
Less: Brokerage paid (2% of Rs.66,000)	1,320
Net sale consideration	64,680
Less: Cost of acquisition	NIL
Long term capital gain (C)	64,680
∴ Long term capital gain (A+B+C)	**20,240**

Note: Cost of acquisition of bonus shares acquired before 1.4.1981 is the FMV as on 1.4.1981 (being the higher of the cost or the FMV as on 1.4.1981).

(b) The long-term capital gains on transfer of equity shares through a recognized stock exchange on which securities transaction tax is paid is exempt from tax under section 10(38). Hence, the taxable capital gain is Nil.

Illustration 11

On January 31, 2010, Mr. A has transferred self-generated goodwill of his profession for a sale consideration of Rs.70,000 and incurred expenses of Rs.5,000 for such transfer. You are required to compute the capital gains chargeable to tax in the hands of Mr. A for the assessment year 2010-11.

Solution

The transfer of self-generated goodwill of profession is not chargeable to tax. It is based upon the Supreme Court's ruling in *CIT vs. B.C. Srinivasa Setty*. Hence, there is no taxable capital gains.

Illustration 12

Mr. R holds 1000 shares in Star Minus Ltd., an unlimited company, acquired in the year 1981-82 at a cost of Rs.25,000. He has been offered right shares by the company in the month of August, 2009 at Rs.40 per share, in the ratio of 2 for every 5 held. He retains 50% of the rights and renounces the balance right shares in favour of Mr. Q for Rs.10 per share in September 2009. All the shares are sold of by Mr. R for Rs.170 per share in January 2010 and Mr. Q sells his shares in December 2009 at Rs.130 per share.

What are the capital gains taxable in the hands of Mr.R and Mr.Q?

Financial year	Cost Inflation Index
1981-82	100
2009-10	632

Solution

Computation of capital gains in the hands of Mr. R for the A.Y.2010-11

Particulars	Rs
1000 Original shares	
Sale proceeds (1000 × Rs.170)	1,70,000
Less : Indexed cost of acquisition [Rs.25,000 × 632/100]	1,58,000
Long term capital gain (A)	12,000

200 Right shares	
Sale proceeds (200 × Rs.170)	34,000
Less : Cost of acquisition [Rs.40 × 200] [note 1]	8,000
Short term capital gain (B)	26,000
200 Right shares renounced in favour of Mr. Q	
Sale proceeds (200 × Rs.10)	2,000
Less : Cost of acquisition [note 2]	NIL
Short term capital gain (C)	2,000
Capital Gains (A+B+C)	**40,000**

Note 1: Since the holding period of these shares is less than 1 year, they are short term capital assets and hence cost of acquisition will not be indexed.

Note 2: The cost of the rights renounced in favour of another person for a consideration is taken to be nil. The consideration so received is taxed as short-term capital gains in full. The period of holding is taken from the date of the rights offer to the date of the renouncement.

Computation of capital gains in the hands of Mr. Q for the A.Y.2010-11

Particulars	**Rs**
200 shares :	
Sale proceeds (200 × Rs.130)	26,000
Less : Cost of acquisition [200 shares × (Rs.10 + Rs.40)] [note]	10,000
Short term capital gain	16,000

Note: The cost of the rights is the amount paid to Mr. R as well as the amount paid to the company. Since the holding period of these shares is less than 1 year, they are short term capital assets and hence, cost of acquisition should not be indexed.

7.15 COMPUTATION OF CAPITAL GAINS IN CASE OF DEPRECIABLE ASSET [SECTION 50]

(i) Section 50 provides for the computation of capital gains in case of depreciable assets. It may be noted that where the capital asset is a depreciable asset forming part of a block of assets, section 50 will have overriding effect in spite of anything contained in section 2(42A) which defines a short-term capital asset.

Accordingly, where the capital asset is an asset forming part of a block of assets in respect of which depreciation has been allowed, the provisions of sections 48 and 49 shall

be subject to the following modification:

Where the full value of consideration received or accruing for the transfer of the asset plus the full value of such consideration for the transfer of any other capital asset falling with the block of assets during previous year exceeds the aggregate of the following amounts namely:

(1) expenditure incurred wholly and exclusively in connection with such transfer;

(2) WDV of the block of assets at the beginning of the previous year;

(3) the actual cost of any asset falling within the block of assets acquired during the previous year

such excess shall be deemed to be the capital gains arising from the transfer of short-term capital assets.

Where all assets in a block are transferred during the previous year, the block itself will cease to exist. In such a situation, the difference between the sale value of the assets and the WDV of the block of assets at the beginning of the previous year together with the actual cost of any asset falling within that block of assets acquired by the assessee during the previous year will be deemed to be the capital gains arising from the transfer of short-term capital assets.

(ii) Cost of acquisition in case of power sector assets [Section 50A]

With respect to the power sector, in case of depreciable assets referred to in section 32(1)(i), the provisions of sections 48 and 49 shall apply subject to the modification that the WDV of the asset (as defined in section 43(6)), as adjusted, shall be taken to be the cost of acquisition.

7.16 CAPITAL GAINS IN RESPECT OF SLUMP SALES [SECTION 50B]

(i) Any profits or gains arising from the slump sale effected in the previous year shall be chargeable to income-tax as capital gains arising from the transfer of long-term capital assets and shall be deemed to be the income of the previous year in which the transfer took place.

Short term capital gains - Any profits and gains arising from such transfer of one or more undertakings held by the assessee for not more than thirty-six months shall be deemed to be short-term capital gains [Sub-section (1)].

(ii) The net worth of the undertaking or the division, as the case may be, shall be deemed to be the cost of acquisition and the cost of improvement for the purposes of sections 48 and 49 in relation to capital assets of such undertaking or division transferred by way of such sale and the provisions contained in the second proviso to section 48 shall be ignored [Sub-section (2)].

(iii) Every assessee in the case of slump sale shall furnish in the prescribed form along with the return of income, a report of a chartered accountant indicating the computation of net worth of the undertaking or division, as the case may be, and certifying that the net worth of the undertaking or division has been correctly arrived at in accordance with the provisions of this section [Sub-section (3)].

Explanation 1 to the section defines the expression "net worth" as the aggregate value of total assets of the undertaking or division as reduced by the value of liabilities of such undertaking or division as appearing in the books of account. However, any change in the value of assets on account of revaluation of assets shall not be considered for this purpose.

Explanation 2 provides that the aggregate value of total assets of such undertaking or division shall be as follows:

(i) In the case of depreciable assets: the written down value of block of assets determined in accordance with the provisions contained in sub-item (C) of item (i) of section 43(6)(c);

(ii) In case of capital assets in respect of which the whole of the expenditure has been allowed or is allowable as a deduction under section 35AD : Nil;

(ii) for all other assets : Book value.

7.17 SPECIAL PROVISION FOR FULL VALUE OF CONSIDERATION IN CERTAIN CASES [SECTION 50C]

(i) Where the consideration received or accruing as a result of transfer of a capital asset, being land or building or both, is less than the value adopted or assessed *or assessable* by any authority of a State Government (Stamp Valuation Authority) for the purpose of payment of stamp duty in respect of such asset, such value adopted or assessed *or assessable* shall be deemed to be the full value of the consideration received or accruing as a result of such transfer. [Sub-section (1)].

(ii) Where the assessee claims before an Assessing Officer that the value so adopted or assessed *or assessable* by the authority for payment of stamp duty exceeds the fair market value of the property as on the date of transfer and the value so adopted or assessed *or assessable* by such authority has not been disputed in any appeal or revision or no reference has been made before any other authority, court or High Court, the Assessing Officer may refer the valuation of the capital asset to a valuation officer as defined in section 2(r) of the Wealth-tax Act, 1957. Where any reference has been made before any other authority, Court or the High Court, the provisions of section 16A (relating to reference to Valuation Officer), section 23A (dealing with appealable orders before Commissioner (Appeals), section 24 (order of Appellate Tribunal), section 34AA (appearance by registered valuer), section 35 (rectification of mistakes) and section 37

(power to take evidence on oath) of the Wealth-tax Act, 1957, shall, with necessary modifications, apply in relation to such reference as they apply in relation to a reference made by the Assessing Officer under sub-section (1) of section 16A of that Act [Sub-section (2)].

(iii) Where the value ascertained by such valuation officer exceeds the value adopted or assessed *or assessable* by the Stamp authority the value adopted or assessed *or assessable* shall be taken as the full value of the consideration received or accruing as a result of the transfer [Sub-section (3)].

(iv) The term "assessable" has been added to cover transfers executed through power of attorney. The term 'assessable' has been defined to mean the price which the stamp valuation authority would have, notwithstanding anything to the contrary contained in any other law for the time being in force, adopted or assessed, if it were referred to such authority for the purposes of the payment of stamp duty.

7.18 ADVANCE MONEY RECEIVED [SECTION 51]

It is possible for an assessee to receive some advance in regard to the transfer of capital asset. Due to the break-down of the negotiation, the assessee may have retained the advance. Section 51 provides that while calculating capital gains, the above advance retained by the assessee must go to reduce the cost of acquisition. However, if advance has been received and retained by the previous owner and not the assessee himself, then the same will not go to reduce the cost of acquisition of the assessee.

Illustration 13

Mr. Kay purchases a house property on April 10, 1978 for Rs.35,000. The fair market value of the house property on April 1, 1981 was Rs.70,000. On August 31, 1984, Mr. Kay enters into an agreement with Mr. Jay for sale of such property for Rs.1,20,000 and received an amount of Rs.10,000 as advance. However, as Mr. Jay did not pay the balance amount, Mr. Kay forfeited the advance. In May 1987, Mr. Kay constructed the first floor by incurring a cost of Rs.50,000. Subsequently, in September 1987, Mr. Kay gifted the house to his friend Mr. Dee. On February 10, 2010, Mr. Dee sold the house for Rs.8,00,000.

Financial year	Cost Inflation Index
1981-1982	100
1984-1985	125
1987-1988	150
2009-2010	632

You are required to compute the capital gains taxable in the hands of Mr. Dee for the assessment year 2010-11.

Solution

Computation of taxable capital gains of Mr.Dee for A.Y.2010-11

Particulars	Rs.
Sale consideration	8,00,000
Less: Indexed cost of acquisition (note)	2,94,933
Indexed cost of improvement (note)	2,10,667
Long-term capital gain	2,94,400

Note: For the purpose of capital gains, holding period is considered from the date on which the house was purchased by Mr. Kay, till the date of sale. However, indexation of cost of acquisition is considered from the date on which the house was gifted by Mr. Kay to Mr. Dee, till the date of sale. i.e. from September 1987 (P.Y. 1987-88) to February 2010 (P.Y. 2009-10).

Indexed cost of acquisition = $\frac{70,000}{150} \times 632$ = Rs.2,94,933

Indexed cost of improvement = $\frac{50,000}{150} \times 632$ = Rs.2,10,667

Amount forfeited by previous owner, Mr. Kay, will not be considered.

Illustration 14

Mr.X purchases a house property in December 1975 for Rs.1,25,000 and an amount of Rs.75,000 was spent on the improvement and repairs of the property in March, 1981. The property was proposed to be sold to Mr.Z in the month of May, 2003 and an advance of Rs.40,000 was taken from him. As the entire money was not paid in time, Mr.X forfeited the advance and subsequently sold the property to Mr.Y in the month of March, 2010 for Rs.25,00,000. The fair value of the property on April 1, 1981 was Rs.3,90,000. What is the capital gain chargeable in the hands of Mr.X for the A.Y. 2010-11?

Financial year	Cost Inflation Index
1981-82	100
2003-04	463
2009-10	632

Solution

Capital gains in the hands of Mr. X for the A.Y. 2010-11 is computed as under:

Particulars	Rs
Sale proceeds	25,00,000
Less : Indexed cost of acquisition [Note 1]	22,12,000
Indexed cost of improvement [Note 2]	-
Long term capital gains	2,88,000
Note 1: Computation of indexed cost of acquisition	
Cost of acquisition (higher of Fair market value as on April 1, 1981 and the actual cost of acquisition)	3,90,000
Less : Advance taken and forfeited	40,000
Cost for the purposes of indexation	3,50,000
Indexed cost of acquisition (Rs.3,50,000 x 632/100)	22,12,000

Note 2 : Any improvement cost incurred prior to 1.4.1981 is to be ignored when fair market value as on 1.4.1981 is taken into consideration.

7.19 EXEMPTION OF CAPITAL GAINS

(i) Capital Gains on sale of residential house [Section 54]

Eligible assessees – Individual & HUF

Conditions to be fulfilled

- There should be a transfer of residential house (buildings or lands appurtenant thereto)
- It must be a long-term capital asset
- Income from such house should be chargeable under the head "Income from house property"
- A new residential house should be –
  - purchased within 1 year before or 2 years after the date of transfer (or)
  - constructed within a period of 3 years after the date of transfer.

Quantum of Exemption

- If cost of new residential house ≥ Capital gains, entire capital gains is exempt.
- If cost of new residential house < Capital gains, capital gains to the extent of cost of new residential house is exempt

Examples

- Example 1 - If the capital gains is Rs.5 lakhs and the cost of the new house is Rs.7 lakhs, then the entire capital gains of Rs.5 lakhs is exempt.
- Example 2 - If capital gains is Rs.5 lakhs and cost of new house is Rs.3 lakhs, then capital gains is exempt only upto Rs.3 lakhs. Balance Rs.2 lakhs is taxable @ 20%.

Consequences of transfer of new asset before 3 years

- If the new asset is transferred before 3 years from the date of its acquisition, then cost of the asset will be reduced by capital gains exempted earlier for computing short-term capital gains.
- Continuing Example 1, if the new house was sold after 2 years for Rs.8 lakhs, then short term capital gain chargeable to tax would be –

Net Consideration		8,00,000
Less: Cost of acquisition	7,00,000	
Less: Capital gains exempt earlier	5,00,000	2,00,000
Short term capital gains chargeable to tax		6,00,000

Illustration 15

Mr. Cee purchased a residential house on July 20, 2007 for Rs.10,00,000 and made some additions to the house incurring Rs.2,00,000 in August 2007. He sold the house property in April 2009 for Rs.20,00,000. Out of the sale proceeds, he spent Rs.5,00,000 to purchase another house property in September 2009.

Financial year	Cost Inflation Index
2006-07	519
2007-08	551
2009-10	632

What is the amount of capital gains taxable in the hands of Mr. Cee for the A.Y.2010-11?

Solution

The house is sold before 36 months from the date of purchase. Hence, the house is a short-term capital asset and no benefit of indexation would be available.

Particulars	Rs.
Sale consideration	20,00,000
Less: Cost of acquisition	10,00,000
Cost of improvement	2,00,000
Short-term capital gains	**8,00,000**

Note: The exemption of capital gains under section 54 is available only in case of long-term capital asset. As the house is short-term capital asset, Mr. Cee cannot claim exemption under section 54. Thus, the amount of taxable short-term capital gains is Rs.8,00,000.

(ii) Capital Gains on transfer of agricultural land [Section 54B]

Eligible assessee – Individual

Conditions to be fulfilled

- There should be a transfer of urban agricultural land.
- Such land must have been used for agricultural purposes either by the assessee himself or his parents in the 2 immediately preceding years.
- He should purchase another agricultural land (urban or rural) within 2 years from the date of transfer.

Quantum of exemption

- If cost of new agricultural land ≥ Capital gains (short-term or long-term), entire capital gains is exempt.
- If cost of new agricultural land < Capital gains (short-term or long-term), capital gains to the extent of cost of new agricultural land is exempt.

Examples

- Example 1 - If the capital gains is Rs.3 lakhs and the cost of the new agricultural land is Rs.4 lakhs, then the entire capital gains of Rs.3 lakhs is exempt.
- Example 2 - If capital gains is Rs.3 lakhs and cost of new agricultural land is Rs.2 lakhs, then capital gains is exempt only upto Rs.2 lakhs.

Consequences of transfer of new agricultural land before 3 years

- If the new agricultural land is transferred before 3 years from the date of its acquisition, then cost of the land will be reduced by capital gains exempted earlier for computing short-term capital gains.
- However, if the new agricultural land is a rural agricultural land, there would be no capital gains on transfer of such land.

Continuing Example 1, if the new agricultural land (urban land) is sold after, say, 2 years for Rs.6 lakhs, then short term capital gain chargeable to tax would be –

Net consideration		6,00,000
Less: Cost of new agricultural land		
Cost of acquisition	4,00,000	
Less: Capital gains exempt earlier	3,00,000	
		1,00,000
Short-term capital gains chargeable to tax		**5,00,000**

(iii) Capital Gains on transfer by way of compulsory acquisition of land and building [Section 54D]

Eligible assessee – Any assessee

Conditions to be fulfilled

- There must be compulsory acquisition of land and building forming part of an industrial undertaking.
- The land and building should have been used by the assessee for purposes of the business of the industrial undertaking in the 2 years immediately preceding the date of transfer.
- The assessee must purchase any other land or building or construct any building (for shifting or re-establishing the existing undertaking or setting up a new industrial undertaking) within 3 years from the date of transfer.

Quantum of exemption

- If cost of new asset ≥ Capital gains, entire capital gains (short-term or long-term) is exempt.
- If cost of new asset < Capital gains, capital gains (short-term or long-term) to the extent of cost of new asset is exempt.

Consequences of transfer of new asset before 3 years

- If the new asset is transferred before 3 years from the date of its acquisition, then cost of the asset will be reduced by capital gains exempted earlier for computing short-term capital gains

Illustration 16

PQR Ltd., purchased a building for industrial undertaking in May 2003, at a cost of Rs.4,00,000. The above property was compulsorily acquired by the State Government at a compensation of Rs.7,00,000 in the month of January, 2010. The compensation was received in March, 2010. The company purchased another building for its industrial undertaking at a cost of Rs.1,00,000 in the month of March, 2010. What is the amount of the capital gains chargeable to tax in the hands of the company for the A.Y. 2010-11?

Financial year	Cost Inflation Index
2003-04	463
2009-10	632

Solution

Computation of capital gains in the hands of PQR Ltd. for the A.Y.2010-11

Particulars	Rs
Sale proceeds (Compensation received)	7,00,000
Less : Indexed cost of acquisition [Rs.4,00,000 × 632/463]	5,46,004
	1,53,996
Less : Exemption under section 54D (Cost of acquisition of new undertaking)	1,00,000
Taxable long term capital gain	**53,996**

(iv) Capital Gains not chargeable on investment in certain bonds [Section 54EC]

Eligible assessee – Any assessee

Conditions to be fulfilled

- There should be transfer of a long-term capital asset.
- Such asset can also be a depreciable asset held for more than 36 months.
- The capital gains arising from such transfer should be invested in a long-term specified asset within 6 months from the date of transfer.
- Long-term specified asset means specified bonds, redeemable after 3 years, issued by the National Highways Authority of India (NHAI) or the Rural Electrification Corporation Limited (RECL).
- The assessee should not transfer or convert or avail loan or advance on the security of such bonds for a period of 3 years from the date of acquisition of such bonds.

Other points

- In case of conversion of capital asset into stock in trade and subsequent sale of stock in trade - period of 6 months to be reckoned from the date of sale of stock in trade for the purpose of section 54EC exemption [CBDT Circular No.791 dated 2-6-2000].
- Receipt of money on liquidation of company – is chargeable to tax in the hands of shareholders [Section 46(2)] – However, there is no transfer of capital asset in such a case – Therefore, exemption under section 54EC is not available – *CIT v. Ruby Trading Co. (P) Ltd. 259 ITR 54 (Raj.)*

Quantum of exemption

- Capital gains or amount invested in specified bonds, whichever is lower.

Violation of condition

- In case of transfer or conversion of such bonds or availing loan or advance on security of such bonds before the expiry of 3 years, the capital gain exempted earlier shall be taxed as long-term capital gain in the year of violation of condition.

(v) Capital gains in cases of investment in residential house [Section 54F]

Eligible assessees: Individuals / HUFs

Conditions to be fulfilled

- There must be transfer of a long-term capital asset, not being a residential house.
- Transfer of plot of land is also eligible for exemption
- The assessee should -
  - Purchase a residential house within a period of 1 year before or 2 years after the date of transfer; or
  - Construct a residential house within 3 years from the date of transfer.
- The assessee should not own more than one residential house on the date of transfer.
- The assessee should not –
  - purchase any other residential house within a period of one year or
  - construct any other residential house within a period of 3 years

  from the date of transfer of the original asset.

Quantum of exemption

- If cost of new residential house ≥ Net sale consideration of original asset, entire capital gains is exempt.
- If cost of new residential house < Net sale consideration of original asset, only proportionate capital gains is exempt i.e.

$$\text{LTCG} \times \frac{\text{Amount invested in new residential house}}{\text{Net sale consideration}}$$

Illustration 17

From the following particulars, compute the taxable capital gains of Mr.D for A.Y.2010-11-

Cost of jewellery [Purchased in F.Y.1990-91]	Rs.1,82,000
Sale price of jewellery sold in Jan 2010	Rs.7,50,000

Expenses on transfer	Rs.7,000
Residential house purchased in March 2010	Rs.5,00,000

Solution

Computation of taxable capital gains for A.Y.2010-11

Particulars		Rs.
Gross consideration		7,50,000
Less: Expenses on transfer		7,000
Net consideration		7,43,000
Less: Indexed cost of acquisition	$1{,}82{,}000 \times \frac{632}{182}$	6,32,000
		1,11,000
Less: Exemption u/s 54F	$1{,}11{,}000 \times \frac{5{,}00{,}000}{7{,}43{,}000}$	74,697
Taxable capital gains		**36,303**

Consequences if the new house is transferred within a period of 3 years

- Short-term capital gains would arise on transfer of the new house; and
- The capital gains exempt earlier under section 54F would be taxable as long-term capital gains.

In the given illustration, if the new residential house is sold for Rs.6,00,000 after say, 1 year, then

- Rs.1,00,000 [i.e. Rs.6,00,000 (-) Rs.5,00,000] would be chargeable as short-term capital gain of that year in which the new house is sold.
- Rs.74,697, being the capital gains exempt earlier, would be taxable as long-term capital gains of that year in which the new house is sold.

(vi) Capital gains for shifting of industrial undertaking from urban areas [Section 54G]

Eligible assessees: Any assessee

7.44 Income Tax

Conditions to be fulfilled

- There should be a shifting of the industrial undertaking from an urban area to any other area
- There should be a transfer of machinery, plant, building or land or any right in building or land used for the business of an industrial undertaking situated in an urban area.
- Such transfer should be in the course of or in consequence of shifting the industrial undertaking from an urban area to any other area.
- The capital gain (short-term or long-term) should be utilized for any of the following purposes within 1 year before or 3 years after the date of transfer –
  - purchase of new plant and machinery
  - acquisition of building or land or construction of building
  - expenses on shifting of the industrial undertaking from the urban area to the other area
  - such other expenditure as the Central Government may specify

Quantum of exemption

- If cost of new assets plus expenses incurred for the specified purpose ≥ Capital gains, entire capital gains (short-term or long-term) is exempt.
- If cost of new assets plus expenses incurred for the specified purpose < Capital gains, capital gains (short-term or long-term) to the extent of such cost and expenses is exempt.

Consequences if the new asset is transferred within a period of 3 years

- If the new asset is transferred within a period of 3 years of its purchase or construction, then the capital gain, which was exempt earlier under section 54G would be deducted from the cost of acquisition of the new asset for the purpose of computation of short-term capital gains in respect of the transfer of the new asset

(vii) Exemption of capital gains on transfer of certain capital assets in case of shifting of an industrial undertaking from an urban area to any SEZ [Section 54GA]

Eligible assesses – Any assessee

Conditions to be fulfilled

- There must be transfer of capital assets
- Such transfer must be effected in the course of, or in consequence of the shifting of an industrial undertaking from an urban area to any SEZ, whether developed in an urban area or not.

- The capital asset should be either machinery or plant or building or land or any rights in building or land used for the purposes of the business of an industrial undertaking situated in an urban area.
- The assessee should, within a period of 1 year before or 3 years after the date of transfer,
  - purchase machinery or plant for the purposes of business of the industrial undertaking in the SEZ;
  - acquire building or land or construct building for the purposes of his business in the SEZ;
  - shift the industrial undertaking and transfer the establishment of such undertaking to the SEZ; and
  - incur expenses for such other purposes as may be specified in a scheme framed by the Central Government.

Quantum of exemption

- If cost of new assets plus expenses incurred for shifting ≥ Capital gains, entire capital gains (short-term or long-term) is exempt.
- If cost of new assets plus expenses incurred for shifting < Capital gains, capital gains (short-term or long-term) to the extent of such cost and expenses is exempt.

Consequences if the new asset is transferred within a period of 3 years

- If the new asset is transferred within a period of 3 years of its purchase or construction, then the capital gain, which was exempt earlier under section 54G would be deducted from the cost of acquisition of the new asset for the purpose of computation of short-term capital gains in respect of the transfer of the new asset.

(viii) Capital Gains Account Scheme (CGAS)

Under sections 54, 54B, 54D, 54F, 54G and 54GA, capital gains is exempt to the extent of investment of such gains / net consideration (in the case of section 54F) in specified assets within the specified time. If such investment is not made before the date of filing of return of income, then the capital gain or net consideration (in case of exemption under section 54F) has to be deposited under the CGAS.

Time limit - Such deposit in CGAS should be made before filing the return of income or on or before the due date of filing the return of income, whichever is earlier. Proof of such deposit should be attached with the return. The deposit can be withdrawn for utilization for the specified purposes in accordance with the scheme.

7.46 Income Tax

Consequences if the amount deposited in CGAS is not utilized within the stipulated time of 2 years / 3 years - If the amount deposited is not utilized for the specified purpose within the stipulated period, then the **unutilized amount shall be charged as capital gain** of the previous year in which the specified period expires. In the case of section 54F, proportionate amount will be taxable.

CBDT Circular No.743 dated 6.5.96 clarifies that in the event of death of an individual before the stipulated period, the unutilized amount is not chargeable to tax in the hands of the legal heirs of the deceased individual. Such unutilized amount is not income but is a part of the estate devolving upon them.

(ix) Extension of time for acquiring new asset or depositing or investing amount of Capital Gain [Section 54H]

In case of compulsory acquisition of the original asset, where the compensation is not received on the date of transfer, the period available for acquiring a new asset or making investment in CGAS under sections 54, 54B, 54D, 54EC and 54F would be considered from *the date of receipt of such compensation* and not from the date of the transfer.

7.20 REFERENCE TO VALUATION OFFICER [SECTION 55A]

Section 55A provides that the Assessing Officer may refer the valuation of a capital asset to a Valuation Officer in the following circumstances with a view to ascertaining the fair market value of the capital asset for the purposes of capital gains -

(i) In a case where the value of the asset as claimed by the assessee is in accordance with the estimate made by a registered valuer, if the Assessing Officer is of the opinion that the value so claimed is less than its fair market value.

(ii) If the Assessing Officer is of the opinion that the fair market value of the asset exceeds the value of the asset as claimed by the assessee by more than 15% of the value of asset as claimed or by more than Rs.25,000 of the value of the asset as claimed by the assessee.

(iii) The Assessing Officer is of the opinion that, having regard to the nature of asset and other relevant circumstances, it is necessary to make the reference.

Where any such reference is made as per this section, the provisions of section 16A of the Wealth-tax Act shall be applicable in relation to such reference as they apply in relation to a reference made by the Assessing Officer under section 16A of that Act.

7.21 SHORT TERM CAPITAL GAINS TAX IN RESPECT OF EQUITY SHARES/UNITS OF AN EQUITY ORIENTED FUND [SECTION 111A]

(i) This section provides for a concessional rate of tax (i.e. 15%) on the short-term capital gains on transfer of -

(1) an equity share in a company or

(2) a unit of an equity oriented fund.

(ii) The conditions for availing the benefit of this concessional rate are –

(1) the transaction of sale of such equity share or unit should be entered into on or after 1.10.2004, being the date on which Chapter VII of the Finance (No. 2) Act, 2004 came into force; and

(2) such transaction should be chargeable to securities transaction tax under the said Chapter.

(iii) The proviso to this section provides that in the case of resident individuals or HUF, if the basic exemption is not fully exhausted by any other income, then the short-term capital gain will be reduced by the unexhausted basic exemption limit and only the balance would be taxed at 15%. However, the benefit of availing the basic exemption limit is not available in the case of non-residents.

(iv) Deductions under Chapter VI-A cannot be availed in respect of such short-term capital gains on equity shares of a company or units of an equity oriented mutual fund included in the total income of the assessee.

The expression "equity oriented fund" has the same meaning assigned to it in the explanation to section 10(38) of the Act i.e. "Equity oriented fund" means a fund –

(1) where the investible funds are invested by way of equity shares in domestic companies to the extent of more than 65% of the total proceeds of such fund; and

(2) which has been set up under a scheme of a Mutual Fund specified under clause (23D).

7.22 TAX ON LONG-TERM CAPITAL GAINS [SECTION 112]

(i) Where the total income of an assessee includes long-term capital gains, tax is payable by the assessee @20% on such long-term capital gains. The treatment of long-term capital gains in the hands of different types of assessees are as follows -

(1) Resident individual or Hindu undivided family:

Income-tax payable at normal rates on total income as reduced by long-term capital gains plus 20% on such long-term capital gains.

However, where the total income as reduced by such long-term capital gains is below the maximum amount which is not chargeable to income-tax then such long-term capital gains shall be reduced by the amount by which the total income as so reduced falls short of the maximum amount which is not chargeable to income-tax and the tax on the balance of such long-term capital gains will be calculated @ 20%.

7.48 Income Tax

(2) Domestic Company:

Long-term capital gains will be charged @ 20%.

(3) Non-corporate non-resident / foreign company:

Long-term capital gains will be charged @20%.

(4) Residents (other than those included in (i) above)

Long-term capital gains will be charged @20%.

(ii) The proviso to section 112 states that where the tax payable in respect of any income arising from the transfer of listed securities or units or zero coupon bonds, being long-term capital assets, exceeds 10% of the amount of capital gains before indexation, then such excess shall be ignored while computing the tax payable by the assessee.

(iii) For this purpose, "listed securities" means securities as defined by section 2(h) of the Securities Contracts (Regulation) Act, 1956; and "unit" means unit of a mutual fund specified under section 10(23D) or of the Unit Trust of India.

(iv) The provisions of section 112 make it clear that the deductions under chapter VIA cannot be availed in respect of the long-term capital gains included in the total income of the assessee.

7.23 EXEMPTION OF LONG TERM CAPITAL GAINS ON SALE OF EQUITY SHARES/ UNITS OF AN EQUITY ORIENTED FUND [SECTION 10(38)]

(i) Section 10(38) exempts long term capital gains on sale of equity shares of a company or units of an equity oriented fund on or after 1.10.2004, being the date on which Chapter VII of the Finance (No.2) Act, 2004 comes into force.

(ii) This exemption is available only if such transaction is chargeable to securities transaction tax.

(iii) However, such long term capital gains exempt under section 10(38) shall be taken into a account in computing the book profit and income tax payable under section 115JB.

(iv) For the purpose of this clause, “Equity oriented fund” means a fund –

(1) where the investible funds are invested by way of equity shares in domestic companies to the extent of more than 65% of the total proceeds of such fund; and

(2) which has been set up under a scheme of Mutual Fund specified under clause (23D).

(v) The percentage of equity share holding of the fund should be computed with reference to the annual average of the monthly averages of the opening and closing figures.

7.24 SECURITIES LENDING AND BORROWING SCHEME

Securities and Exchange Board of India (SEBI) vide Circular No. MRD/DoP/SE/DEP/Cir. 14/2007, dated 20-12-2007, has decided to permit all classes of investors (individuals, institutional, etc.) to short sell. Further, with a view to provide a mechanism for borrowing of securities to enable settlement of securities sold short, SEBI has also decided to put in place a full-fledged Securities Lending and Borrowing (SLB) Scheme for all market participants in the Indian securities market under the overall framework of Securities Lending Scheme, 1997 of SEBI.

In this context, the following taxation issues have arisen in respect of transactions under the scheme of securities lending -

(i) Would the lending/borrowing of securities under the Securities Lending Scheme amount to a transfer under section 2(47) in the hands of the lender?

(ii) Would lending/borrowing of the securities be subject to Securities Transaction Tax (STT)?

The Lending and Borrowing of Securities under the new scheme notified by SEBI vide Circular No. MRD/DoP/SE/DEP/Cir.14/2007, dated 20-12-2007 is in accordance with the overall framework of the Securities Lending Scheme of 1997. Accordingly, the provisions of section 47(xv) will be equally applicable in respect of the transactions under the new scheme.

Securities Transaction Tax (STT) is levied on purchase or sale of an equity share, unit and derivative, under such circumstances as specified in section 98 of the Finance (No. 2) Act, 2004. The transactions in the nature of lending and borrowing under the new scheme do not fall within the scope of section 98 to the Finance (No.2) Act, 2004. Therefore, the transactions of lending and borrowing are not liable to Securities Transaction Tax (STT).

Self-examination questions

1. Discuss the conditions to be satisfied for claiming exemption of tax in respect of -
   (a) Capital gains on compulsory acquisition of agricultural land situated within specified urban limits
   (b) Capital gains on sale of listed equity shares/units of an equity oriented fund.
2. Write short notes on -
   (i) Capital gains in the case of slump sale under section 50B
   (ii) Reference to Valuation Officer under section 55A

3. What is the tax treatment, under the Income-tax Act, of capital gains arising on transfer of assets in case of shifting of industrial undertaking from an urban area to any special economic zone? Discuss.

4. List ten transactions which are not regarded as transfer for the purpose of capital gains.

5. Ganesh, a resident individual, bought 1,000 equity shares of Rs.10 each of XYZ Ltd. at Rs.50 per share on 3.4.2009. He sold 700 equity shares at Rs.35 per share on 31.8.2009 and the remaining 300 shares at Rs.25 per share on 1.11.2009. XYZ Ltd. declared a dividend of 50%, the record date being 30.6.2009. Ganesh sold on 5.1.2010, a house from which he derived a long-term capital gain of Rs.75,000.

   Compute the amount of capital gain arising to Ganesh for the A.Y. 2010-11.

6. Can the expenditure incurred by an assessee to remove an encumbrance be allowed as a deduction under section 48, in the following cases -

   (a) where the mortgage was created by the assessee himself;

   (b) where the mortgage was created by the previous owner.

   Discuss with reference to a recent case law.

7. Where a holding company receives assets on voluntary liquidation of its subsidiary company by virtue of being a shareholder of the subsidiary company, would the value of assets received by the holding company on the date of distribution be liable to tax?

8. The word 'otherwise' used in section 45(4) takes into its fold not only cases of dissolution but also cases of subsisting partners of a partnership, transferring assets in favour of a retiring partner. Discuss.

9. What is the cost of acquisition in a case where the previous owner himself acquired the asset by any of the modes set out in section 49(1)?

Answers

6. This question came up before the Bombay High Court in *CIT v. Roshanbabu Mohammed Hussein Merchant (2005) 144 Taxman 720 / 275 ITR 0231.* The High Court pointed out that there is a distinction between the obligation to discharge the mortgage debt created by the previous owner and the obligation to discharge the mortgage debt created by the assessee himself. Where the property acquired by the assessee is subject to mortgage created by the previous owner, he acquires absolute interest in that property only after the discharge of mortgage debt. In such a case,

the expenditure incurred by the assessee to discharge the mortgage debt, created by the previous owner, to acquire absolute interest in the property is treated as 'cost of acquisition' and is deductible from the full value of consideration received by the assessee on transfer of that property.

However, where the assessee acquires a property which is unencumbered, he gets absolute interest in that property on acquisition. When the assessee transfers that property, he is liable for capital gains tax on the full value realized, even if he has himself created an encumbrance on that property. The assessee is under an obligation to remove that encumbrance for effectively transferring the property. In other words, the expenditure incurred by the assessee to remove an encumbrance created by himself on the property, acquired by him without any encumbrance, is not an allowable deduction under section 48.

7. This question was answered by the Gujarat High Court in *CIT v. Brahmi Investments (P.) Ltd. (2006) 286 ITR 66*. In this case, the High Court held that if a holding company had received assets on voluntary liquidation of its subsidiary company by virtue of being a shareholder of the subsidiary company, the value of assets received by the holding company on the date of distribution was liable to tax under section 46(2). Section 47(v), which provides that transfer of a capital asset by a subsidiary company to its 100% holding company (being an Indian company) would not be regarded as a transfer for the purpose of charge of capital gains tax, would not be applicable in this case.

8. The Bombay High Court made a landmark judgment in deciding this issue in *Commissioner of Income-tax v. A.N. Naik Associates (2004) 136 Taxman 107.* The Court applied the "mischief rule" about interpretation of statutes and pointed out that the idea behind the introduction of sub-section (4) in section 45 was to plug in a loophole and block the escape route through the medium of the firm.

The High Court observed that the expression 'otherwise' has not to be read *ejusdem generis* with the expression 'dissolution of a firm or body of individuals or association of persons'. The expression 'otherwise' has to be read with the words 'transfer of capital assets by way of distribution of capital assets. If so read, it becomes clear that even when a firm is in existence and there is a transfer of capital asset, it comes within the expression 'otherwise' since the object of the amendment was to remove the loophole which existed, whereby capital gains tax was not chargeable. Therefore, the word 'otherwise' takes into its sweep not only cases of dissolution but also cases of subsisting partners of a partnership, transferring assets in favour of retiring partners.

7.52 Income Tax

9. The Madras High Court, in *CIT v. Theatre Sri Rangaraja (2004) 135 Taxman 269,* observed that the *Explanation* to section 49(1) makes it clear that where the previous owner of an asset which was sold had himself acquired it by any of the modes set out in section 49(1)(i) to (iv), it is the cost incurred by the owner who had owned the asset prior to the previous owner that is required to be taken into account and not the cost incurred by the previous owner at the time he received the asset in any of the modes set out in sub-clauses (i) to (iv) of section 49(1).

8

INCOME FROM OTHER SOURCES

8.1 INTRODUCTION

Any income, profits or gains includible in the total income of an assessee, which cannot be included under any of the preceding heads of income, is chargeable under the head 'Income from other sources'. Thus, this head is the residuary head of income and brings within its scope all the taxable income, profits or gains of an assessee which fall outside the scope of any other head. Therefore, when any income, profit or gain does not fall precisely under any of the other specific heads but is chargeable under the provisions of the Act, it would be charged under this head.

8.2 INCOMES CHARGEABLE UNDER THIS HEAD [SECTION 56]

(i) The following income shall be chargeable only under the head 'Income from other sources':

(1) Dividend income [covered by sections 2(22)(a) to (e)].

(2) Casual income in the nature of winning from lotteries, crossword puzzles, horse races, card games and other games of any sort, gambling, betting etc. Such winnings are chargeable to tax at a flat rate of 30% under section 115BB.

(3) Any sum of money, received without consideration by an individual or a HUF from any person or persons *before 1.10.2009* , if the aggregate value exceeds Rs.50,000 i.e. where any sum of money is received without consideration by an individual or a Hindu undivided family from any person or persons and the aggregate value of all such sums received during the previous year exceeds Rs.50,000, the whole of the aggregate value of such sum shall be included in the total income of such individual or Hindu undivided family under the head "Income from other sources".

In order to avoid hardships in genuine cases, certain sums of money received have been exempted –

(1) any sum received from any relative; or

(2) any sum received on the occasion of the marriage of the individual; or

(3) any sum received under a will or by way of inheritance; or

(4) any sum received in contemplation of death of the payer; or

(5) any local authority; or

(6) any fund or foundation or university of other educational institution or hospital or other medical institution or any trust or institution referred to in section 10(23C); or

(7) any trust or institution registered under section 12AA.

For the purpose of this clause, the expression "relative" means –

(i) spouse of the individual,

(ii) brother or sister of the individual,

(iii) brother or sister of the spouse of the individual,

(iv) brother or sister of either of the parents of the individual,

(v) any lineal ascendant or descendant of the individual,

(vi) any lineal ascendant or descendant of the spouse of the individual, and

(vii) spouse of a person referred to in items (2) to (6) mentioned above.

(4) Gift of any sum of money or property or transfer of property for inadequate consideration on or after 1st October, 2009 to be subject to tax in the hands of the recipient

(i) New clause (vii) has been inserted in section 56(2) w.e.f. 1.10.2009 to bring within its scope, in addition to any sum of money, the value of any property received without consideration or for inadequte consideration. For this purpose, "property" means immovable property being land or building or both, shares and securities, jewellery, archaeological collections, drawings, paintings, sculptures or any work of art.

(ii) If an immovable property is received without consideration, the stamp duty value of such property would be taxed as the income of the recipient if it exceeds Rs.50,000. In case an immovable property is received for inadequate consideration, and the difference between the stamp duty value and such consideration exceeds Rs.50,000, such difference would be taxed as the income of the recipient.

(iii) If the stamp duty value of immovable property is disputed by the assessee, the Assessing Officer may refer the valuation of such property to a Valuation Officer. In such a case, the provisions of section 50C and section 155(15) shall, as far as may be, apply for determining the value of such property.

(iv) If movable property is received without consideration, the aggregate fair market value of such property on the date of receipt would be taxed as the income of the recipient if it exceeds Rs.50,000. In case movable property is received for inadequate consideration, and the difference between the aggregate fair market value and such consideration exceeds Rs.50,000, such difference would be taxed as

the income of the recipient. The CBDT would prescribe the method of determination of fair market value of a movable property.

(v) The table below summarises the new scheme of taxability of gifts with effect from 1st October, 2009 -

	Nature of asset	***Particulars***	***Taxable value***
1	*Money*	*Without consideration*	*The whole amount if the same exceeds Rs.50,000.*
2	*Immovable property*	*Without consideration*	*The stamp value of the property, if it exceeds Rs.50,000.*
3	*Immovable property*	*Inadequate consideration*	*The difference between the stamp value and the consideration, if such difference exceeds Rs.50,000*
4	*Movable property*	*Without consideration*	*The aggregate fair market value of the property, if it exceeds Rs.50,000.*
5	*Movable property*	*Inadequate consideration*	*The difference between the aggregate fair market value and the consideration, if such difference exceeds Rs.50,000*

(vi) However, any sum of money or value of 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 as defined in the Explanation to section 10(20); or

(f) from any fund or foundation or university or other educational institution or hospital or other medical institution or any trust or institution referred to in section 10(23C); or

(g) from any trust or institution registered under section 12AA

would be outside the ambit of section 56(2)(vii).

8.4 Income Tax

Illustration 1

Mr. Z received the following gifts during the P.Y.2009-10 from his friend Mr.Y, -

(1) Cash gift of Rs.1,00,000 on his birthday, 19th June, 2009.

(2) 50 shares of B Ltd., the fair market value of which was Rs.1,00,000, on his birthday, 19th June, 2009.

(3) 100 shares of A Ltd., the fair market value of which was Rs.55,000 on the date of transfer. This gift was received on the occasion of Diwali. Mr.Y had originally purchased the shares on 1.7.2009 at a cost of Rs.40,000.

Further, on 17th December, 2009, Mr.Z purchased land from his brother's father-in-law for Rs.3,50,000. The stamp value of land was Rs.5,00,000.

On 1st March, 2010, he sold the 100 shares of A Ltd. for Rs.80,000

Compute the income of Mr.Z chargeable under the head "Income from other sources" and "Capital Gains" for A.Y.2010-11.

Solution

Computation of "Income from Other Sources" of Mr.Z for A.Y.2010-11

	Particulars		Rs.
(1)	Cash gift received before 1.10.2009 is taxable u/s 56(2)(vi) since it exceeds Rs.50,000		1,00,000
(2)	Value of shares of B Ltd. gifted by Mr.Y on 19th June, 2009 is not taxable since only gift of property after 1st October, 2009 is chargeable to tax u/s 56(2)(vii).		-
(3)	Fair market value of shares of A Ltd. is taxable since the gift was made after 1st October, 2009 and the aggregate fair market value exceeds Rs.50,000.		55,000
(4)	Purchase of land for inadequate consideration on 17.12.2009 would attract the provisions of section 56(2)(vii), since the difference between the stamp value and consideration exceeds Rs.50,000. Brother's father-in-law does not fall within the definition of "relative" u/s 56(2).		
	Stamp Value	5,00,000	
	Less: Consideration	3,50,000	1,50,000
Income from Other Sources			**3,05,000**

Computation of "Capital Gains" of Mr.Z for the A.Y.2010-11

Sale Consideration	80,000
Less: Cost of acquisition [deemed to be the fair market value charged to tax under section 56(2)(vii)]	55,000
Short-term capital gains	**25,000**

(5) Interest received on compensation/enhanced compensation deemed to be income in the year of receipt and taxable under the head "Income from Other Sources" [Sections 56(2)(viii)]

(i) As per section 145(1), income chargeable under the head "Profits and gains of business or profession" or "Income from other sources", shall be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee.

(ii) Further, the Hon'ble Supreme Court has, in Rama Bai v. CIT (1990) 181 ITR 400, held that arrears of interest computed on delayed or on enhanced compensation shall be taxable on accrual basis. The tax payers are facing genuine difficulty on account of this ruling, since the interest would have accrued over a number of years, and consequently the income of all the years would undergo a change.

(iii) Therefore, to remove this difficulty, clause (b) has been inserted in section 145A to provide that the interest received by an assessee on compensation or on enhanced compensation shall be deemed to be his income for the year in which it is received, irrespective of the method of accounting followed by the assessee.

(iv) Clause (viii) has been inserted in section 56(2) to provide that income by way of interest received on compensation or on enhanced compensation referred to in clause (b) of section 145A shall be assessed as "Income from other sources" in the year in which it is received.

(ii) The following income are chargeable under the head "Income from other sources" only if such income are not chargeable under the head "Profits and gains of business or profession" -

(1) Any sum received by an employer-assessee from his employees as contributions to any provident fund, superannuation fund or any other fund for the welfare of the employees

(2) Interest on securities

(3) Income from letting out on hire, machinery, plant or furniture.

(4) Where letting out of buildings is inseparable from the letting out of machinery, plant or furniture, the income from such letting.

(iii) Any sum received under a Keyman insurance policy including the sum allocated by

way of bonus on such policy is chargeable under the head "Income from other sources" if such income is not chargeable under the head "Profits and gains if business or profession" or under the head "Salaries" i.e. if such sum is received by any person other than the employer who took the policy and the employee in whose name the policy was taken.

(iv) Any income chargeable to tax under the Act, but not falling under any other head of income shall be chargeable to tax under the head "Income from other sources" e.g. Salary received by an MPs/MLAs will not be chargeable to income-tax under the head 'Salary' but will be chargeable as "Income from other sources" under section 56.

8.3 BOND WASHING TRANSACTIONS AND DIVIDEND STRIPPING [SECTION 94]

(i) A bond-washing transaction is a transaction where securities are sold some time before the due date of interest and reacquired after the due date is over. This practice is adopted by persons in the higher income group to avoid tax by transferring the securities to their relatives/friends in the lower income group just before the due date of payment of interest. In such a case, interest would be taxable in the hands of the transferee, who is the legal owner of securities. In order to discourage such practice, section 94(1) provides that where the owner of a security transfers the security just before the due date of interest and buys back the same immediately after the due date and interest is received by the transferee, such interest income will be deemed to be the income of the transferor and would be taxable in his hands.

(ii) In order to prevent the practice of sale of securities-cum-interest, section 94(2) provides that if an assessee who has beneficial interest in securities sells such securities in such a manner that either no income is received or income received is less than the sum he would have received if such interest had accrued from day to day, then income from such securities for the whole year would be deemed to be the income of the assessee.

(iii) Section 94(7) provides that where

(a) any person buys or acquires any securities or unit within a period of three months prior to the record date and

(b) such person sells or transfers –

  (1) such securities within a period of three months after such date, or

  (2) such unit within a period of nine months after such date and

(c) the dividend or income on such securities or unit received or receivable by such person is exempted,

then, the loss, if any, arising therefrom shall be ignored for the purposes of computing his income chargeable to tax. Such loss should not exceed the amount of dividend or income received or receivable on such securities or unit.

8.4 APPLICABLE RATE OF TAX IN RESPECT OF CASUAL INCOME [SECTION 115BB]

(i) This section provides that income by way of winnings from lotteries, crossword puzzles, races including horse races or card games and other games of any sort or from gambling or betting of any form would be taxed at a flat rate of 30% plus surcharge, if applicable, plus education cess plus secondary and higher education cess.

(ii) No expenditure or allowance can be allowed from such income.

(iii) Deduction under Chapter VI-A is not allowable from such income.

(iv) Adjustment of unexhausted basic exemption limit is also not permitted against such income.

8.5 DEDUCTIONS ALLOWABLE [SECTION 57]

The income chargeable under the head "Income from other sources" shall be computed after making the following deductions:

(i) In the case of dividends (other than dividends referred to in section 115-O) or interest on securities, any reasonable sum paid by way of commission or remuneration to a banker or any other person for the purpose of realising such dividend or interest on behalf of the assessee.

(ii) Where the income consists of recovery from employees as contribution to any provident fund etc. in terms of clause (x) of section 2(24), then, a deduction will be allowed in accordance with the provisions of section 36(1)(va) i.e. to the extent the contribution is remitted before the due date under the respective Acts.

(iii) Where the income to be charged under this head is from letting on hire of machinery, plant and furniture, with or without building, the following items of deductions are allowable in the computation of such income:

(a) the amount paid on account of any current repairs to the machinery, plant or furniture.

(b) the amount of any premium paid in respect of insurance against risk of damage or destruction of the machinery or plant or furniture.

(c) the normal depreciation allowance in respect of the machinery, plant or furniture, due thereon.

(iv) In the case of income in the nature of family pension, a deduction of a sum equal to $33\frac{1}{3}$ per cent of such income or Rs.15,000, whichever is less, is allowable. For the purposes of this deduction "family pension" means a regular monthly amount payable by the employer to a person belonging to the family of an employee in the event of his death.

(v) Any other expenditure not being in the nature of capital expenditure laid out or expended wholly and exclusively for the purpose of making or earning such income.

(vi) 50% of income by way of compensation/enhanced compensation received chargeable to tax under section 56(2)(viii). No deduction would be allowable under any other clause of section 57 in respect of such income.

Illustration 2

Interest on enhanced compensation received by Mr.G during the previous year 2009-10 is Rs.5,00,000. Out of this interest, Rs.1,50,000 relates to the previous year 2006-07, Rs.1,65,000 relates to previous year 2007-08 and Rs.1,85,000 relates to previous year 2008-09. Discuss the tax implication, if any, of such interest income for A.Y.2010-11.

Solution

The entire interest of Rs.5,00,000 would be taxable in the year of receipt, namely, P.Y.2009-10.

Particulars	Rs.
Interest on enhanced compensation taxable u/s 56(2)(viii)	5,00,000
Less: Deduction under section 57(iv) @50%	2,50,000
Interest chargeable under the head "Income from other sources"	**2,50,000**

Note - The Supreme Court held in *CIT* v. *Rajindra Prasad Moody [1978] 115 ITR 519*, that in order to claim deduction under section 57 in respect of any expenditure, it is not necessary that income should in fact have been earned as a result of the expenditure. In this view of the matter, the Court held that the interest on money borrowed for investment in shares which had not yielded any taxable dividend was admissible as a deduction under section 57 under the head, "Income from other sources".

8.6 DEDUCTIONS NOT ALLOWABLE [SECTION 58]

No deduction shall be made in computing the "Income from other sources" of an assessee in respect of the following items of expenses:

(i) In the case of any assessee:

(1) any personal expense of the assessee;

(2) any interest chargeable to tax under the Act which is payable outside India on which tax has not been paid or deducted at source.

(3) any payment taxable in India as salaries, if it is payable outside India unless tax has been paid thereon or deducted at source.

(ii) In addition to these disallowances, section 58(2) specifically provides that the disallowance of payments to relatives and associate concerns and disallowance of payment

or aggregate of payments exceeding Rs.20,000 made to a person during a day otherwise than by account payee cheque or draft covered by section 40A will be applicable to the computation of income under the head 'Income from other sources' as well.

(iii) Income-tax and wealth-tax paid.

(iv) No deduction in respect of any expenditure or allowance in connection with income by way of earnings from lotteries, cross word puzzles, races including horse races, card games and other games of any sort or from gambling or betting of any form or nature whatsoever shall be allowed in computing the said income.

The prohibition will not, however, apply in respect of the income of an assessee, being the owner of race horses, from the activity of owning and maintaining such horses. In respect of the activity of owning and maintaining race horses, expenses incurred shall be allowed even in the absence of any stake money earned. Such loss shall be allowed to be carried forward in accordance with the provisions of section 74A.

8.7 DEEMED INCOME CHARGEABLE TO TAX [SECTION 59]

The provisions of section 41(1) are made applicable, so far as may be, to the computation of income under this head. Accordingly, where a deduction has been made in respect of a loss, expenditure or liability and subsequently any amount is received or benefit is derived in respect of such expenditure incurred or loss or trading liability allowed as deduction, then it shall be deemed as income in the year in which the amount is received or the benefit is accrued.

8.8 METHOD OF ACCOUNTING [SECTION 145]

Income chargeable under the head "Income from other sources" has to be computed in accordance with the cash or mercantile system of accounting regularly employed by the assessee. However, deemed dividend u/s 2(22)(e) is chargeable to tax on payment basis under section 8, irrespective of the method of accounting followed by the assessee.

Self-examination questions

1. Write short notes on -
   a) Bond washing transactions
   b) Dividend stripping
2. State the incomes which are chargeable only under the head "Income from other sources".
3. Which are incomes chargeable under the head "Income from other sources" only if they are not chargeable under the head "Profits and gains of business or profession"?
4. What are the deductions allowable from the following income -

a) Dividend

b) Income from letting on hire machinery, plant or furniture.

5. What are the inadmissible deductions while computing income under the head "Income from other sources".

6. Is family pension taxable under the head "Salaries" or "Income from other sources"? Is any deduction allowable from such income? Discuss.

7. Explain whether the method of accounting followed by an assessee is relevant in computing his income under the head "Income from other sources".

8. Explain the meaning and tax treatment of casual income under the Income-tax Act.

9. Mr.A has borrowed Rs.5,00,000@10% for investment in shares of domestic companies and foreign companies. He earned dividend of Rs.7,500 from domestic companies and Rs.12,500 from foreign companies. He claimed that interest paid by him on money borrowed for investment is deductible from dividend income. Discuss whether the claim of Mr.A is valid in law.

10. Karan's bank account shows the following deposits during the financial year 2009-10. Compute his total income for the A.Y. 2010-11, assuming that his income from house property (computed) is Rs.62,000.

(i)	Gift from his sister in Amsterdam	Rs.2,30,000
(ii)	Gift from his friend on his birthday	Rs.10,000
(iii)	Dividend from shares of various Indian companies	Rs.12,600
(iv)	Gift from his mother's friend on his engagement	Rs.25,000
(v)	Gift from his fianceé	Rs.75,000
(vi)	Interest on bank deposits	Rs.25,000

Answer

10. Rs.1,97,000

9

INCOME OF OTHER PERSONS INCLUDED IN ASSESSEE'S TOTAL INCOME

9.1 CLUBBING OF INCOME – AN INTRODUCTION

Under the Income-tax Act, 1961, an assessee is generally taxed in respect of his own income. However, there are certain cases where as assessee has to pay tax in respect of income of another person. The provisions for the same are contained in sections 60 to 65 of the Act. These provisions have been enacted to counteract the tendency on the part of the tax-payers to dispose of their property or transfer their income in such a way that their tax liability can be avoided or reduced.

For example, in the case of individuals, income-tax is levied on a slab system on the total income. The tax system is progressive i.e. as the income increases, the applicable rate of tax increases. Some taxpayers in the higher income bracket have a tendency to divert some portion of their income to their spouse, minor child etc. to minimize their tax burden. In order to prevent such tax avoidance, clubbing provisions have been incorporated in the Act, under which income arising to certain persons (like spouse, minor child etc.) have to be included in the income of the person who has diverted his income for the purpose of computing tax liability.

9.2 TRANSFER OF INCOME WITHOUT TRANSFER OF THE ASSET [SECTION 60]

(i) If any person transfers the income from any asset without transferring the asset itself, such income is to be included in the total income of the transferor.

(ii) It is immaterial whether the transfer is revocable or irrevocable and whether it was made before the commencement of this Act or after its commencement.

(iii) For example, Mr.A confers the right to receive rent in respect of his house property on his wife, Mrs.A, without transferring the house itself to her. In this case, the rent received by Mrs.A will be clubbed with the income of Mr.A.

9.3 INCOME ARISING FROM REVOCABLE TRANSFER OF ASSETS [SECTION 61]

(i) All income arising to any person by virtue of a revocable transfer of assets is to be

included in the total income of the transferor.

(ii) As per section 63, the transfer is deemed to be revocable if—

(a) it contains any provision for the retransfer, directly or indirectly, of the whole or any part of the income or assets to the transferor, or

(b) it gives, in any way to the transferor, a right to reassume power, directly or indirectly, over the whole or any part of the income or the assets.

(iii) This clubbing provision will operate even if only part of income of the transferred asset had been applied for the benefit of the transferor. Once the transfer is revocable, the entire income from the transferred asset is includible in the total income of the transferor.

9.4 EXCEPTIONS WHERE CLUBBING PROVISIONS ARE NOT ATTRACTED EVEN IN CASE OF REVOCABLE TRANSFER [SECTION 62]

Section 61 will not apply in the following two cases -

(i) **Transfer not revocable during the life time of the beneficiary or the transferee -** If there is a transfer of asset which is not revocable during the life time of the transferee, the income from the transferred asset is not includible in the total income of the transferor provided the transferor derives no direct or indirect benefit from such income. If the transferor receives direct or indirect benefit from such income, such income is to be included in his total income even though the transfer may not be revocable during the life time of the transferee.

(ii) **Transfer made before April 1, 1961 and not revocable for a period exceeding six years -** Income arising from the transfer of an asset before 1.4.61, which was not revocable for a period exceeding six years, is not includible in the total income of the transferor provided the transferor does not derive direct or indirect benefit from such income.

In both the above cases, as and when the power to revoke the transfer arises, the income arising by virtue of such transfer will be included in the total income of the transferor.

9.5 CLUBBING OF INCOME ARISING TO SPOUSE [SECTION 64(1)(ii)]

9.5.1 Income by way of remuneration from a concern in which the individual has substantial interest

(i) In computing the total income of any individual, all such income which arises, directly or indirectly, to the spouse of such individual by way of salary, commission, fees or any other form of remuneration, whether in cash or in kind, from a concern in which such individual has a substantial interest shall be included.

(ii) However, this provision does not apply where the earning spouse of the said individual possesses technical or professional qualifications and the income to the spouse is solely attributable to the application of his/her technical or professional knowledge or experience. In such an event, the income arising to such spouse is to be assessed in his/her hands.

(iii) Where both husband and wife have substantial interest in a concern and both are in receipt of income by way of salary etc. from the said concern, such income will be includible in the hands of that spouse, whose total income, excluding such income is higher.

(iv) Where any such income is once included in the total income of either spouse, income arising in the succeeding year shall not be included in the total income of the other spouse unless the Assessing Officer is satisfied, after giving that spouse an opportunity of being heard, that it is necessary to do so.

(v) An individual shall be deemed to have substantial interest in a concern under the following circumstances -

(a) If the concern is a company, equity shares carrying not less than 20% of the voting power are, at any time during the previous year, owned beneficially by such person or partly by such person and partly by one or more of his relatives.

(b) In any other case, if such person is entitled, or such person and one or more of his relatives are entitled in the aggregate, at any time during the previous year, to not less than 20% of the profits of such concern.

The term 'relative' in relation to an individual means the husband, wife, brother or sister or any lineal ascendant or descendant of that individual.

Illustration 1

Mr. A is an employee of X Ltd. and he has 25% shares of that company. His salary is Rs.50,000 p.m. Mrs. A is working as a computer software programmer in X Ltd. at a salary of Rs.30,000 p.m. She is, however, not qualified for the job. Compute the gross total income of Mr.A and Mrs. A for the A.Y.2010-11, assuming that they do not have any other income.

Solution

Mr.A is an employee of X Ltd and has 25% shares of X Ltd i.e. a substantial interest in the company. His wife is working in the same company without any professional qualifications for the same.

Thus, by virtue of the clubbing provisions of the Act, the salary received by Mrs. A from X Ltd. will be clubbed in the hands of Mr. A.

Computation of Gross total income of Mr. A

Salary received by Mr. A	[Rs.50,000 × 12]	Rs.6,00,000
Salary received by Mrs. A	[Rs.30,000 × 12]	Rs.3,60,000
Gross total income		**Rs.9,60,000**

The gross total income of Mrs. A is nil.

Illustration 2

Will your answer be different if Mrs. A was qualified for the job?

Solution

If Mrs.A possesses professional qualifications for the job, then the clubbing provisions shall not be applicable.

Gross total income of Mr. A = Salary received by Mr. A [Rs.50,000 × 12]=Rs.6,00,000

Gross total income of Mrs.A = Salary received by Mrs.A [Rs.30,000×12]=Rs.3,60,000

Illustration 3

Mr. B is an employee of Y Ltd. and has substantial interest in the company. His salary is Rs.20,000 p.m. Mrs. B is also working in Y Ltd. at a salary of Rs.12,000 p.m. without any qualifications. Mr. B also receives Rs.30,000 as interest on securities. Mrs. B owns a house property which she has let out. Rent received from tenants is Rs.6000 p.m. Compute the gross total income of Mr. B and Mrs. B for the A.Y.2010-11.

Solution

Since Mrs. B is not professionally qualified for the job, the clubbing provisions shall be applicable.

Computation of Gross total income of Mr.B

Income from Salary		**Rs.**
Salary received by Mr.B	[Rs.20,000 × 12]	2,40,000
Salary received by Mrs.B	[Rs.12,000 × 12]	1,44,000
		3,84,000
Income from other sources		
Interest on securities		30,000
		4,14,000

Computation of Gross total income of Mrs.B

		Rs.	**Rs.**
Income from Salary			Nil
[clubbed in the hands of Mr. B]			
Income from house property			
Gross Annual Value	[Rs.6,000 × 12]	72,000	
Less: Municipal taxes paid		-	
Net Annual Value (NAV)		**72,000**	

Less: Deductions u/s 24		
- 30% of NAV i.e. 30% of Rs.72,000	21,600	
- Interest on loan	-	50,400
Gross total income		**50,400**

9.5.2 Income arising to the spouse from an asset transferred without adequate consideration [Section 64(1)(iv)]

(i) Where there is a transfer of an asset (other than house property), directly or indirectly, from one spouse to the other, otherwise than for adequate consideration or in connection with an agreement to live apart, any income arising to the transferee from the transferred asset, either directly or indirectly, shall be included in the total income of the transferor.

(ii) In the case of transfer of house property, the provisions are contained in section 27. If an individual transfers a house property to his spouse, without adequate consideration or otherwise than in connection with an agreement to live apart, the transferor shall be deemed to be the owner of the house property and its annual value will be taxed in his hands.

(iii) It may be noted that any income from the accretion of the transferred asset is not to be clubbed with the income of the transferor.

(iv) The income arising on transferred assets alone have to be clubbed. However, income earned by investing such income (arising from transferred asset) cannot be clubbed.

(v) It is also to be noted that natural love and affection do not constitute adequate consideration. Therefore, where an asset is transferred without adequate consideration, the income from such asset will be clubbed in the hands of the transferor.

(vi) Where the assets transferred, directly or indirectly, by an individual to his spouse are invested by the transferee in the business, proportionate income arising from such investment is to be included in the total income of the transferor. If the investment is in the nature of contribution of capital, proportionate interest on capital will be clubbed with the income of the transferor. Such proportion has to be computed by taking into account the value of the aforesaid investment as on the first day of the previous year to the total investment in the business by the transferee as on that day.

9.6 TRANSFER OF ASSETS FOR THE BENEFIT OF THE SPOUSE [SECTION 64(1)(vii)] - All income arising directly or indirectly to any persons or association of persons, from the assets transferred, directly or indirectly, without adequate consideration is includible in the income of the transferor to the extent such income is used by the transferee for the immediate or deferred benefit of the transferor's spouse.

9.6 Income Tax

9.7 INCOME ARISING TO SON'S WIFE FROM THE ASSETS TRANSFERRED WITHOUT ADEQUATE CONSIDERATION BY THE FATHER-IN-LAW OR MOTHER-IN-LAW [SECTION 64(1)(vi)]

(i) Where an asset is transferred, directly or indirectly, by an individual to his or her son's wife without adequate consideration, the income from such asset is to be included in the total income of the transferor.

(ii) For this purpose, where the assets transferred directly or indirectly by an individual to his son's wife are invested by the transferee in the business, proportionate income arising from such investment is to be included in the total income of the transferor. If the investment is in the nature of contribution of capital, the proportionate interest on capital will be clubbed with the income of the transferor. Such proportion has to be computed by taking into account the value of the aforesaid investment as on the first day of the previous year to the total investment in the business by the transferee as on that day.

9.8 TRANSFER OF ASSETS FOR THE BENEFIT OF SON'S WIFE [SECTION 64(1)(viii)] - All income arising directly or indirectly, to any person or association of persons from the assets transferred, directly or indirectly, without adequate consideration will be included in the total income of the transferor to the extent such income is used by the transferee for the immediate or deferred benefit of the transferor's son's wife.

9.9 CLUBBING OF MINOR'S INCOME [SECTION 64(1A)]

(i) All income of a minor is to be included in the income of his parent.

(ii) However, the income derived by the minor from manual work or from any activity involving his skill, talent or specialised knowledge or experience will not be included in the income of his parent.

(iii) The income of the minor will be included in the income of that parent, whose total income is greater.

(iv) Once clubbing of minor's income is done with that of one parent, it will continue to be clubbed with that parent only, in subsequent years. The Assessing Officer, may, however, club the minor's income with that of the other parent, if, after giving the other parent an opportunity to be heard, he is satisfied that it is necessary to do so.

(v) Where the marriage of the parents does not subsist, the income of the minor will be includible in the income of that parent who maintains the minor child in the relevant previous year.

(vi) Section 10(32) provides that where the income of an individual includes the income of his minor child, the individual shall be entitled to exemption of such income subject to a maximum of Rs.1,500 per child. This provision is to provide relief to the individuals in

whose total income, the income of the minor child is included.

(vii) However, the income of a minor child from suffering from any disability of the nature specified in section 80U shall not be included in the hands of the parent but shall be assessed in the hands of the child.

(viii) It may be noted that the clubbing provisions are attracted even in respect of income of minor married daughter.

Illustration 4

Mr. A has three minor children – two twin daughters and one son. Income of the twin daughters is Rs.2,000 p.a. each and that of the son is Rs.1,200 p.a. Compute the income, in respect of minor children, to be clubbed in the hands of Mr. A.

Solution

Taxable income, in respect of minor children, in the hands of Mr. A is

Twin minor daughters	[Rs.2,000 × 2]	Rs.4,000	
Less: Exempt u/s 10(32)	[Rs.1,500 × 2]	Rs.3,000	Rs.1,000
Minor son		Rs.1,200	
Less: Exempt u/s 10(32)		Rs.1,200	Nil
Income to be clubbed in the hands of Mr.A			**Rs.1,000**

9.10 CROSS TRANSFERS

In the case of cross transfers also (e.g., A making gift of Rs.50,000 to the wife of his brother B for the purchase of a house by her and a simultaneous gift by B to A's minor son of shares in a foreign company worth Rs.50,000 owned by him), the income from the assets transferred would be assessed in the hands of the deemed transferor if the transfers are so intimately connected as to form part of a single transaction, and each transfer constitutes consideration for the other by being mutual or otherwise. Thus, in the instant case, the transfers have been made by A and B to persons who are not their spouse or minor child so as to circumvent the provisions of this section, showing that such transfers constituted consideration for each other.

The Supreme Court, in case of *CIT* v. *Keshavji Morarji [1967] 66 ITR 142,*observed that if two transactions are inter-connected and are parts of the same transaction in such a way that it can be said that the circuitous method was adopted as a device to evade tax, the implication of clubbing provisions would be attracted. Accordingly, the income arising to Mrs. B from the house property should be included in the total income of B and the dividend from

shares transferred to A's minor son would be taxable in the hands of A. This is because A and B are the indirect transferors to their minor child and spouse respectively, of the income yielding assets, so as to reduce their burden of taxation.

9.11 CONVERSION OF SELF-ACQUIRED PROPERTY INTO THE PROPERTY OF A HINDU UNDIVIDED FAMILY [SECTION 64(2)]

Section 64(2) deals with the case of conversion of self-acquired property into property of a Hindu undivided family.

(i) Where an individual, who is a member of the HUF, converts at any time after 31-12-1969, his individual property into property of the HUF of which he is a member or throws such property into the common stock of the family or otherwise transfers such individual property, directly or indirectly, to the family otherwise than for adequate consideration, the income from such property shall continue to be included in the total income of the individual.

(ii) Where the converted property has been partitioned, either by way of total or partial partition, the income derived from such converted property as is received by the spouse on partition will be deemed to arise to the spouse from assets transferred indirectly by the individual to the spouse and consequently, such income shall also be included in the total income of the individual who effected the conversion of such property.

(iii) Where income from the converted property is included in the total income of an individual under section 64(2), it will be excluded from the total income of the family or, as the case may be, of the spouse of the individual.

9.12 INCOME INCLUDES LOSS

It is significant to note that as per the *Explanation 2* to section 64, 'income' would include 'loss'. Accordingly, where the specified income to be included in the total income of the individual is a loss, such loss will be taken into account while computing the total income of the individual. It is significant to note that this *Explanation* applies to clubbing provisions under both sections 64(1) and 64(2).

9.13 DISTINCTION BETWEEN SECTION 61 AND SECTION 64

It may be noted that the main distinction between the two sections is that section 61 applies only to a revocable transfer made by any person while section 64 applies to revocable as well as irrevocable transfers made only by individuals.

9.14 LIABILITY OF PERSON IN RESPECT OF INCOME INCLUDED IN THE INCOME OF ANOTHER PERSON [SECTION 65]

Sections 61 to 64 provide for clubbing of income of one person in the hands of the other in circumstances specified therein. However, service of notice of demand (in respect of tax on such income) may be made upon the person to whom such asset is transferred (i.e. the transferee). In such a case, the transferee is liable to pay that portion of tax levied on the transferor which is attributable to the income so clubbed.

Self-examination questions

1. Write short notes on the following in the context of clubbing of income -
   a) Substantial interest
   b) Transfer and revocable transfer.
2. Under what circumstances can an income arising to the spouse of an individual be included in the income of the individual? Discuss.
3. State when the income arising to the son's wife can be included in the hands of the individual.
4. Discuss the provisions of the Income-tax Act regarding inclusion of the income of minor child in the assessment of the parent. Enumerate the exception to this provision.
5. Write a short note on cross transfers, explaining the meaning and tax treatment of the same, in the context of clubbing of income.
6. Discuss the tax consequences arising on conversion of self-acquired property into joint family property.
7. Compute the total income of Mr. & Mrs. A for the A.Y.2010-11 from the following information relevant for P.Y.2009-10 -

	Particulars	Rs.
(a)	Salary income (computed) of Mrs. A	2,30,000
(b)	Income from profession of Mr. A	3,90,000
(c)	Income of minor son B from company deposit	15,000
(d)	Income of minor daughter C from application of her painting skills	32,000
(e)	Interest from bank received by C on deposit made out of income earned by application of her painting skills	3,000
(f)	Gift received by C from friend of Mrs. A	2,500

8. A proprietory business was started by Smt. Poorna in the year 2007. As on 1.4.2008 her capital in business was Rs.3,00,000.

   Her husband gifted Rs.2,00,000, on 10.4.2008, which amount Smt. Poorna invested in her business on the same date. Smt. Poorna earned profits from her proprietory business for the P.Y.2008-09, Rs.1,50,000 and P.Y.2009-10, Rs.3,90,000. Compute the income to be clubbed in the hands of Poorna's husband for the A.Y.2010-11 with reasons.
9. Dinesh, an individual engaged in the business of finance, advances Rs.5 lacs to his HUF on interest at 12% p.a., which is the prevailing market rate. The HUF invests the amount in its business and earns profit of Rs.2 lacs from this money. Can the Assessing Officer add a sum of Rs.1,40,000 (i.e. Rs.2,00,000 - Rs.60,000) as income of Dinesh under section 64(2) of the Income-tax Act?

9.10 Income Tax

10. Mr. Ram has a salary income (computed) of Rs.2,50,000 for the P.Y.2009-10. His minor son, Arjun, has agricultural income of Rs.1,20,000 for the same year. The Assessing Officer clubbed the income of the minor son for determining the rate of income-tax applicable to Mr. Ram. However, Mr.Ram contended that agricultural income was exempt under section 10 and also not specified in the definition of income under section 2(24). Therefore, agricultural income of minor son should not be clubbed and the provisions of section 64(1A) are not attracted in this case. Discuss the correctness or otherwise of Mr. Ram's contention.

Answers

9. Section 64(2) shall be applicable only where an individual member of HUF converts his property into the property of HUF or throws it into the common stock of the HUF without adequate consideration. In this case, Dinesh does not transfer money to his HUF but only lends an amount of Rs.5 lakhs to his HUF at an interest of 12%, which is the prevailing market rate. This is a transaction of loan, which pre-supposes re-payment. Dinesh continues to be the owner of the amount lent. Thus, there is no transfer of property from Dinesh to the HUF. Therefore, the Assessing Officer cannot add the profit arising to HUF in the total income of Dinesh by invoking section 64(2).

10. The facts of the case are similar to the case of *Suresh Chand Talera v. Union of India (2006) 152 Taxman 348 (M.P).* In this case, the High Court observed that the definition of income under section 2(24) is inclusive and not exhaustive. Hence, the fact that agricultural income has not been specified as one of the items in section 2(24) does not mean that agricultural income is not included in the word "income" wherever the word "income" has been used in the Act. Section 10 of the Act provides that in computing the income of the previous year of a person, any income falling in any of the clauses mentioned therein shall not be included. The first clause mentioned therein is "agricultural income". Thus, section 10 makes it clear that agricultural income is income but by express provision therein, agricultural income has been excluded from the total income of an assessee for the purpose of levy of income-tax. Section 4(1), which is the charging section, provides that while the total income of a person is to be determined in accordance with the provisions of the Income-tax Act, the rate or rates at which such income-tax will be paid on such income for any assessment year will be stipulated in the relevant Finance Act. The Annual Finance Act provides [under Chapter II section 2] that the net agricultural income shall be taken into account in the manner provided therein for the purpose of determining the rates of income-tax applicable to the income of the assessee. Therefore, in view of the above provisions, the High Court held that agricultural income of the minor son of the assessee has to be included in the income of the assessee for the purpose of determining the rate of income-tax applicable to the income of the assessee.

Therefore, in this case, the contention of Mr. Ram is incorrect. The agricultural income of his minor son, Arjun, has to be included in the income of Mr. Ram for rate purposes, since the words "income as arises or accrues to his minor child" used in section 64(1A) includes agricultural income also.

10

AGGREGATION OF INCOME, SET-OFF AND CARRY FORWARD OF LOSSES

10.1 AGGREGATION OF INCOME

In certain cases, some amounts are deemed as income in the hands of the assessee though they are actually not in the nature of income. These cases are contained in sections 68, 69, 69A, 69B, 69C and 69D. These are discussed in detail in Chapter 1. The Assessing Officer may require the assessee to furnish explanation in such cases. If the assessee does not offer any explanation or the explanation offered by the assessee is not satisfactory, the amounts referred to in these sections would be deemed to be the income of the assessee. Such amounts have to be aggregated with the assessee's income.

10.2. CONCEPT OF SET-OFF AND CARRY FORWARD OF LOSSES

Specific provisions have been made in the Income-tax Act, 1961 for the set-off and carry forward of losses. In simple words, "Set-off" means adjustment of losses against the profits from another source/head of income in the same assessment year. If losses cannot be set-off in the same year due to inadequacy of eligible profits, then such losses are carried forward to the next assessment year for adjustment against the eligible profits of that year. The maximum period for which different losses can be carried forward for set-off has been provided in the Act.

10.3 INTER SOURCE ADJUSTMENT [SECTION 70]

(i) Under this section, the losses incurred by the assessee in respect of one source shall be set-off against income from any other source under the same head of income, since the income under each head is to be computed by grouping together the net result of the activities of all the sources covered by that head. In simpler terms, loss from one source of income can be adjusted against income from another source, both the sources being under the same head.

Example 1: Loss from one house property can be set off against the income from another

house property.

Example 2: Loss from one business, say textiles, can be set off against income from any other business, say printing, in the same year as both these sources of income fall under one head of income. Therefore, the loss in one business may be set-off against the profits from another business in the same year.

(ii) Inter-source set-off, however, is not permissible in the following cases -

(a) Long-term capital loss -

(1) Where the net result in respect of any short term capital asset is a loss, such loss shall be allowed to be set-off against income, if any, for that assessment year under the head "capital gains" in respect of any other capital asset, and

(2) Where the net result in respect of any long-term capital asset is a loss, such loss shall be allowed to be set-off against income, if any, for that assessment year under the head "capital gains" in respect of any other asset not being a short-term capital asset.

Thus, short-term capital loss is allowed to be set off against both short-term capital gain and long-term capital gain. However, long-term capital loss can be set-off only against long-term capital gain and not short-term capital gain.

(b) Speculation loss - A loss in speculation business can be set-off only against the profits of any other speculation business and not against any other business or professional income. However, losses from other business can be adjusted against profits from speculation business.

(c) Loss from the activity of owning and maintaining race horses - See section 74A(3) in para 10.13 of this chapter.

(iii) It must be noted that loss from an exempt source cannot be set-off against profits from a taxable source of income. For example, long-term capital loss on sale of shares sold through a recognized stock exchange cannot be set-off against long-term capital gains on sale of land.

10.4 INTER HEAD ADJUSTMENT [SECTION 71]

Loss under one head of income can be adjusted or set of against income under another head. However, the following points should be considered:

(i) Where the net result of the computation under any head of income (other than 'Capital Gains') is a loss, the assessee can set-off such loss against his income assessable for that assessment year under any other head, including 'Capital Gains'.

(ii) Where the net result of the computation under the head "Profits and gains of business or profession" is a loss, such loss cannot be set off against income under the head "Salaries".

(iii) Where the net result of computation under the head 'Capital Gains' is a loss, such capital loss cannot be set-off against income under any other head.

(iv) Speculation loss and Loss from the activity of owning and maintaining race horses cannot be set off against income under any other head.

Illustration 1

Mr. A submits the following particulars pertaining to the A.Y.2010-11:

Particulars	**Rs.**
Income from salary	4,00,000
Loss from self-occupied property	(-)70,000
Business loss	(-)1,00,000
Bank interest received	80,000

Compute the taxable income of Mr. A for the A.Y.2010-11.

Solution

Computation of taxable income of Mr. A for the A.Y. 2010-11

Particulars	**Amount (Rs)**	**Amount (Rs)**
Income from salary	4,00,000	
Income from house property	(-) 70,000	3,30,000
Business income	(-)1,00,000	
Income from other sources (bank interest)	80,000	
Business loss to be carried forward	(-) 20,000	-
Gross total income [See Note below]		**3,30,000**
Less: Deduction under chapter VIA		Nil
Taxable income		**3,30,000**

Note: Gross Total Income includes salary income of Rs.3,30,000 after adjusting house property loss. Business loss of Rs.1,00,000 is set off against bank interest of Rs.80,000 and remaining business loss of Rs.20,000 will be carried forward as it cannot be set off against salary income.

10.4 Income Tax

10.5 SET-OFF AND CARRY FORWARD OF LOSS FROM HOUSE PROPERTY [SECTION 71B]

(i) In any assessment year, if there is a loss under the head 'Income from house property', such loss will first be set-off against income from any other head during the same year.

(ii) If such loss cannot be so set-off, wholly or partly, the unabsorbed loss will be carried forward to the following assessment year to be set-off against income under the head 'Income from house property'.

(iii) The loss under this head is allowed to be carried forward upto 8 assessment years immediately succeeding the assessment year in which the loss was first computed.

(iv) For example, loss from one house property can be adjusted against the profits from another house property in the same assessment year. Any loss under the head 'Income from house property' can be set off against any income under any other head in the same assessment year. However, if after such set off, there is still any loss under the head "Income from house property", then the same shall be carried forward to the next year.

(v) It is to be remembered that once a particular loss is carried forward, it can be set off only against the income from the same head in the forthcoming assessment years.

10.6 CARRY FORWARD AND SET-OFF OF BUSINESS LOSSES [SECTIONS 72 & 80]

Under the Act, the assessee has the right to carry forward the loss in cases where such loss cannot be set-off due to the absence or inadequacy of income under any other head in the same year. The loss so carried forward can be set-off against the profits of subsequent previous years.

Section 72 covers the carry forward and set-off of losses arising from a business or profession.

Conditions

The assessee's right to carry forward business losses under this section is, however, subject to the following conditions:-

(i) The loss should have been incurred in business, profession or vocation.

(ii) The loss should not be in the nature of a loss in the business of speculation.

(iii) The loss may be carried forward and set-off against the income from business or profession though not necessarily against the profits and gains of the same business or profession in which the loss was incurred. But a loss carried forward cannot, under any circumstances, be set-off against the income from any head other than

"Profits and gains of business or profession".

(iv) The loss can be carried forward and set off only against the profits of the assessee who incurred the loss. That is, only the person who has incurred the loss is entitled to carry forward or set off the same. Consequently, the successor of a business cannot carry forward or set off the losses of his predecessor except in the case of succession by inheritance.

(v) A business loss can be carried forward for a maximum period of 8 assessment years immediately succeeding the assessment year in which the loss was incurred.

(vi) As per section 80, the assessee must have filed a return of loss under section 139(3) in order to carry forward and set off a loss. In other words, the non-filing of a return of loss disentitles the assessee from carrying forward the loss sustained by him. Such a return should be filed within the time allowed under section 139(1). However, this condition does not apply to a loss from house property carried forward under section 71B and unabsorbed depreciation carried forward under section 32(2).

Illustration 2

Mr. B, a resident individual, furnishes the following particulars for the P.Y. 2009-10:

Particulars	Rs.
Income from salary (Net)	45,000
Income from house property	(24,000)
Income from business – non-speculative	(22,000)
Income from speculative business	(4,000)
Short-term capital gains	(25,000)
Long-term capital gains	19,000

What is the total income chargeable to tax for the A.Y. 2010-11?

Solution

The total income chargeable to tax for the A.Y. 2010-11 is calculated as under:

Particulars	Amount (Rs)	Amount (Rs.)
Income from salaries	45,000	
Income from house property	(24,000)	21,000
Profits and gains of business and profession		
Business loss to be carried forward [Note 1]	(22,000)	
Speculative loss to be carried forward [Note 2]	(4,000)	

10.6 Income Tax

Capital Gains		
Long term capital gain	19,000	
Short term capital loss	(25,000)	
Short term capital loss to be carried forward [Note 3]	(6,000)	
Taxable income		**21,000**

Note 1: Business loss cannot be set-off against salary income. Therefore, loss of Rs.22,000 from the non-speculative business cannot be set off against the income from salaries. Hence, such loss has to be carried forward to the next year for set-off against business profits, if any.

Note 2: Loss of Rs.4,000 from the speculative business can be set off only against the income from the speculative business. Hence, such loss has to be carried forward.

Note 3: Short term capital loss can be set off against both short term capital gain and long term capital gain. Therefore, short term capital loss of Rs.25,000 can be set-off against long-term capital gains to the extent of Rs.19,000. The balance short term capital loss of Rs.6,000 cannot be set-off against any other income and has to be carried forward to the next year for set-off against capital gains, if any.

10.7 CARRY FORWARD AND SET-OFF OF ACCUMULATED BUSINESS LOSSES AND UNABSORBED DEPRECIATION ALLOWANCE IN CERTAIN CASES OF AMALGAMATION / DEMERGER, ETC. [SECTION 72A]

(i) Amalgamation - This section applies where there has been an amalgamation of –

(1) a company owning an industrial undertaking or a ship or a hotel with another company or an amalgamation of a banking company with a specified bank; or

(2) public sector companies engaged in the business of operation of aircrafts.

It provides that the accumulated loss and unabsorbed depreciation of the amalgamating company shall be deemed to be the loss or depreciation, as the case may be, of the amalgamated company for the previous year in which the amalgamation took place. Other provisions of the Act relating to set off and carry forward shall also apply accordingly.

Conditions for availing benefit under this section

(1) Conditions to be fulfilled by the amalgamating company

(i) The amalgamating company should have been engaged in the business, in which the accumulated loss occurred or depreciation remains unabsorbed, for 3 or more years.

(ii) The amalgamating company has held continuously as on the date of amalgamation, at least 3/4th of the book value of the fixed assets held by it, 2 years prior to the date of amalgamation.

(2) Conditions to be fulfilled by the amalgamated company

(i) The amalgamated company should hold at least 3/4th in the book value of fixed assets of the amalgamating company acquired as a result of amalgamation for a minimum period of 5 years from the effective date of amalgamation.

(ii) The amalgamated company continues the business of the amalgamating company for at least 5 years.

(iii) The amalgamated company must also fulfill such other conditions prescribed under Rule 9C for the revival of the business of the amalgamating company or to ensure that the amalgamation is for genuine business purpose -

(1) The amalgamated company shall achieve the level of production of at least 50% of the installed capacity (capacity as on the date of amalgamation) of the said undertaking before the end of 4 years from the date of amalgamation and continue to maintain the said minimum level of production till the end of 5 years from the date of amalgamation. Central Government has the power to modify this requirement on an application made by the amalgamated company.

(2) The amalgamated company shall furnish to the Assessing Officer a certificate in Form No.62 verified by a Chartered Accountant in this regard.

In case the above specified conditions are not fulfilled, that part of carry forward of loss and unabsorbed depreciation remaining to be utilized by the amalgamated company shall lapse and such loss or depreciation as has been set-off shall be treated as the income in the year in which there is a failure to fulfill the conditions.

(ii) Demerger - Where there has been a demerger of an undertaking, the accumulated loss and the unabsorbed depreciation directly relatable to the undertaking transferred by the demerged company to the resulting company shall be allowed to be carried forward and set off in the hands of the resulting company.

If the accumulated loss or unabsorbed depreciation is not directly relatable to the undertaking, the same will be apportioned between the demerged company and the resulting company in the same proportion in which the value of the assets have been transferred.

The Central Government is empowered to notify such conditions as it considers necessary to ensure that the demerger or amalgamation is for genuine business purpose.

10.8 Income Tax

(iii) Re-organisation of business [Section 72A(4)]

In case of re-organisation of business, whereby a firm is succeeded by a company as per the provisions of section 47(xiii), or a sole proprietary concern is succeeded by a company as per the provisions of section 47(xiv), then the accumulated business loss and the unabsorbed depreciation of the firm / proprietary concern, as the case may be, shall be deemed to be the loss or depreciation allowance of the successor company for the previous year in which the business re-organisation took place. Other provisions of the Act relating to set-off and carry forward will apply accordingly.

However, this facility will not be available if it is found that any of the conditions laid down in the corresponding sub-sections (xiii) and (xiv) of section 47 have not been complied with. In such case, the set-off of loss or allowance of depreciation made in any previous year in the hands of the successor company shall be deemed to be the income of the company chargeable to tax in the year in which the conditions have been violated.

Meanings of certain terms

"Accumulated loss" means so much of the loss of the predecessor firm or the proprietary concern or the amalgamating company or the demerged company, as the case may be, under the head "Profit and gains of business or profession" (not being a loss sustained in a speculation business) which such predecessor firm or the proprietary concern or amalgamating company or demerged company, would have been entitled to carry forward and set off under the provisions of section 72 if the re-organisation of business or amalgamation or demerger had not taken place.

"Unabsorbed depreciation" means so much of the allowance for depreciation of the predecessor firm or the proprietary concern or the amalgamating company or the demerged company, as the case may be, which remains to be allowed and which would have been allowed to the predecessor firm or the proprietary concern or amalgamating company or demerged company, as the case may be, under the provisions of this Act, if the re-organisation of business or amalgamation or demerger had not taken place.

"Industrial undertaking" means any undertaking which is engaged in -

(i) the manufacture or processing of goods;

(ii) the manufacture of computer software;

(iii) the business of generation or distribution of electricity or any other form of power;

(iv) providing telecommunication services, whether basic or cellular, including radio paging, domestic satellite service, network of trunking, broad band network and internet services.

(v) mining;

(vi) the construction of ships, aircraft or rail systems.

"Specified bank" means the State Bank of India (SBI) constituted under the SBI Act, 1955 or a subsidiary bank as defined in the SBI (Subsidiary Banks) Act, 1959 or a corresponding new bank constituted under section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 or under section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980.

10.8 SET-OFF OF LOSSES OF A BANKING COMPANY AGAINST THE PROFIT OF A BANKING INSTITUTION UNDER A SCHEME OF AMALGAMATION [SECTION 72AA]

(i) This section provides for carry forward and set off of accumulated loss and unabsorbed depreciation allowance of a banking company against the profits of a banking institution under a scheme of amalgamation sanctioned by the Central Government.

(ii) Where a banking company has been amalgamated with a banking institution under a scheme sanctioned and brought into force by the Central Government under section 45(7) of the Banking Regulation Act, 1949, the accumulated loss and unabsorbed depreciation of the amalgamating banking company shall be deemed to be the loss or the allowance for depreciation of the banking institution for the previous year in which the scheme of amalgamation is brought into force, and all the provisions contained in the Income-tax Act, 1961, relating to set off and carry forward of loss and unabsorbed depreciation shall apply accordingly.

(iii) The *Explanation* to this section defines the expressions "accumulated loss", "banking company, "banking institution" and "unabsorbed depreciation" as follows –

(a) "accumulated loss" means so much of the loss of the amalgamating banking company under the head "Profits and gains of business or profession" (not being a loss sustained in a speculation business) which such amalgamating banking company, would have been entitled to carry forward and set-off under the provisions of section 72 if the amalgamation had not taken place;

(b) "banking company" shall have the same meaning assigned to it in clause (c) of section 5 of the Banking Regulation Act, 1949;

(c) "banking institution" shall have the same meaning assigned to it in sub-section (15) of section 45 of the Banking Regulation Act, 1949;

(d) "unabsorbed depreciation" means so much of the allowance for depreciation of the amalgamating banking company which remains to be allowed and which would have been allowed to such banking company if the amalgamation had not taken place.

10.9 PROVISIONS RELATING TO CARRY FORWARD AND SET OFF OF ACCUMULATED LOSS AND UNABSORBED DEPRECIATION ALLOWANCE IN BUSINESS REORGANISATION OF CO-OPERATIVE BANKS [SECTION 72AB]

(i) Under this section, in a case where the amalgamation has taken place during the previous year, set-off of accumulated loss and the unabsorbed depreciation of the predecessor co-operative bank will be allowed in the hands of the successor co-operative

bank as if the amalgamation had not taken place. All the other provisions of this Act relating to set off and carry forward of loss and allowance for depreciation would apply accordingly.

(ii) The benefit of carry-forward and set-off of accumulated losses under this section would be allowed only on fulfillment of the following conditions -

(a) Conditions to be fulfilled by the predecessor co-operative bank

(1) It should have been engaged in the business of banking for three or more years; and

(2) It has held at least three-fourths of the book value of fixed assets as on the date of the business reorganisation, continuously for two years prior to the date of business reorganisation;

(b) Conditions to be fulfilled by the successor co-operative bank

(1) It should hold at least three-fourths of the book value of fixed assets of the predecessor co-operative bank acquired through business reorganisation, continuously for a minimum period of five years immediately succeeding the date of business reorganisation;

(2) It continues the business of the predecessor co-operative bank for a minimum period of five years from the date of business reorganisation; and

(3) It fulfils such other conditions as may be prescribed to ensure the revival of the business of the predecessor co-operative bank or to ensure that the business reorganisation is for genuine business purpose.

(iii) The amount of set-off of the accumulated loss and unabsorbed depreciation allowable to the resulting co-operative bank has to be calculated in the following manner -

(1) In a case where the whole of the amount of such loss or unabsorbed depreciation is directly relatable to the undertakings transferred to the resulting co-operative bank - the entire accumulated loss or unabsorbed depreciation of the demerged co-operative bank is allowed to be set-off.

(2) In a case where the accumulated loss or unabsorbed depreciation is not directly relatable to the undertakings transferred to the resulting co-operative bank - the amount which bears the same proportion to the accumulated loss or unabsorbed depreciation of the demerged co-operative bank as the assets of the undertaking transferred to the resulting co-operative bank bears to the assets of the demerged co-operative bank.

For example, if A Co.op Bank is the demerged co-operative bank and B Co. op Bank is the resulting co-operative bank, the amount of set-off of the accumulated loss and unabsorbed depreciation allowable to B Co-op. bank would be –

$$\text{Unabsorbed business loss/depreciation of A Co - Op bank} \times \frac{\text{Assets of the undertaking transferred to B Co - op bank}}{\text{Assets of A Co - op bank}}$$

(iv) The Central Government may specify other conditions by notification in the Official Gazette as it considers necessary, to ensure that the business reorganisation is for genuine business purposes.

(v) The period commencing from the beginning of the previous year and ending on the date immediately preceding the date of business reorganisation, and the period commencing from the date of such business reorganisation and ending with the previous year shall be deemed to be two different previous years for the purposes of set off and carry forward of loss and allowance for depreciation.

For example, if the date on which business re-organisation took place is 1.11.08, then the period between 1.4.08 and 31.10.08 and the period between 1.11.08 and 31.3.09 would be deemed to be two different previous years for the purposes of set-off and carry forward of unabsorbed business losses and depreciation.

(vi) In a case where the conditions specified in (ii) above or notified under (iv) above are not complied with, the set-off of accumulated loss or unabsorbed depreciation allowed in any previous year to the successor co-operative bank shall be deemed to be the income of the successor co-operative bank chargeable to tax for the year in which the conditions are not complied with.

(vii) Accumulated loss means so much of loss of the amalgamating co-operative bank or the demerged co-operative bank, as the case may be, under the head "Profits and gains of business or profession" (not being a loss sustained in a speculation business) which such amalgamating co-operative bank or the demerged co-operative bank, would have been entitled to carry forward and set-off under the provisions of section 72 as if the business reorganisation had not taken place.

(viii) Unabsorbed depreciation means so much of the allowance for depreciation of the amalgamating co-operative bank or the demerged co-operative bank, as the case may be, which remains to be allowed and which would have been allowed to such bank as if the business reorganisation had not taken place.

10.10 LOSSES IN SPECULATION BUSINESS [SECTION 73]

(i) The meaning of the expression 'speculative transaction' as defined in section 43(5) and the treatment of income from speculation business has already been discussed under the head "Profits and gains of business or profession".

(ii) Since speculation is deemed to be a business distinct and separate from any other business carried on by the assessee, the losses incurred in speculation can be neither set

off in the same year against any other non-speculation income nor be carried forward and set off against other income in the subsequent years.

(iii) Therefore, if the losses sustained by an assessee in a speculation business cannot be set-off in the same year against any other speculation profit, they can be carried forward to subsequent years and set-off only against income from any speculation business carried on by the assessee.

(iv) The loss in speculation business can be carried forward only for a maximum period of 4 years from the end of the relevant assessment year in respect of which the loss was computed. Loss from the activity of trading in derivatives, however, is not to be treated as speculative loss.

(v) The *Explanation* to this section discourages companies (other than banking and investment companies) from indulging in speculation business or dealing in shares otherwise than in the ordinary course of their business. It provides that where any part of the business of a company (other than investment company / banking / financing company) consists of the purchase and sale of the shares of other companies, such a company shall be deemed to be carrying on speculation business to the extent to which the business consists of the purchase and sale of such shares. Thus, companies engaged in the business of banking or the granting of loans and advances as their principal business would be exempted from the operation of this Explanation. Accordingly, both investment companies and banking companies would not be treated as carrying on speculation business in cases where they purchase and sell shares of other companies.

(vi) For this purpose, an investment company means a company whose Gross Total Income consists mainly of income which is chargeable under the heads "Income from house property", "Capital gains" and "Income from the other sources".

10.11 CARRY FORWARD & SET OFF OF LOSSES BY SPECIFIED BUSINESS [SECTION 73A]

(i) Any loss computed in respect of the specified business referred to in section 35AD shall be set off only against profits and gains, if any, of any other specified business.

(ii) The unabsorbed loss, if any, will be carried forward for set off against profits and gains of any specified business in the following assessment year and so on.

(iii) There is no time limit specified for carry forward and set-off and therefore, such loss can be carried forward indefinitely for set-off against income from specified business.

10.12 LOSSES UNDER THE HEAD 'CAPITAL GAINS' [SECTION 74]

Section 74 provides that where for any assessment year, the net result under the head 'Capital gains' is short term capital loss or long term capital loss, the loss shall be carried forward to the following assessment year to be set off in the following manner:

(i) Where the loss so carried forward is a short term capital loss, it shall be set off

against any capital gains, short term or long term, arising in that year.

(ii) Where the loss so carried forward is a long term capital loss, it shall be set off only against long term capital gain arising in that year.

(iii) Net loss under the head capital gains cannot be set off against income under any other head.

(iv) Any unabsorbed loss shall be carried forward to the following assessment year up to a maximum of 8 assessment years immediately succeeding the assessment year for which the loss was first computed.

Illustration 3

During the P.Y. 2009-10, Mr. C has the following income and the brought forward losses:

Particulars	Rs.
Short term capital gains on sale of shares	1,50,000
Long term capital loss of A.Y. 2008-09	(96,000)
Short term capital loss of A.Y.2009-10	(37,000)
Long term capital gain	75,000

What is the capital gain taxable in the hands of Mr. C for the A.Y.2010-11?

Solution

The capital gains taxable are as under:

Particulars	Rs.	Rs.
Short term capital gains on sale of shares	1,50,000	
Less: Brought forward short term capital loss of the A.Y.2009-10	(37,000)	1,13,000
Long term capital gain	75,000	
Less: Brought forward long term capital loss of A.Y.2008-09 [See note below]	(75,000)	Nil
Taxable short-term capital gains		**1,13,000**

Note: Long-term capital loss cannot be set off against short-term capital gain. Hence, the remaining unadjusted long term capital loss of A.Y. 2008-09 of Rs.21,000 (i.e. Rs.96,000 – Rs.75,000) has to be carried forward to the next year to be set-off against long-term capital gains of that year.

10.13 LOSSES FROM THE ACTIVITY OF OWNING AND MAINTAINING RACE HORSES [SECTION 74A(3)]

(i) According to provisions of section 74A(3), the losses incurred by an assessee from

the activity of owning and maintaining race horses cannot be set-off against the income from any other source other than the activity of owning and maintaining race horses.

(ii) Such loss can be carried forward for a maximum period of 4 assessment years for being set-off against the income from the activity of owning and maintaining race horses in the subsequent years.

(iii) For this purpose, the "amount of loss incurred by the assessee in the activity of owning and maintaining race horses" means the amount by which such income by way of stake money falls short of the amount of revenue expenditure incurred by the assessee for the purpose of maintaining race horses. i.e. Loss = Stake money – revenue expenditure for the purpose of maintaining race horses.

(iv) Further, the expression 'horse race' means a horse race upon which wagering or betting may be lawfully made.

(v) "Income by way of stake money" means the gross amount of prize money received on a race horse or race horses by the owner thereof on account of the horse or horses or any one or more of the horses winning or being placed second or in any lower position in horse races.

Illustration 4

Mr. D has the following income for the P.Y. 2009-10 -

Particulars	Rs.
Income from the activity of owning and maintaining the race horses	75,000
Income from textile business	85,000
Brought forward textile business loss	50,000
Brought forward loss from the activity of owning and maintaining the race horses (relating to A.Y.2007-08)	96,000

What is the taxable income in the hands of Mr. D for the A.Y. 2010-11?

Solution

The taxable income is calculated as under:

Particulars	Rs.	Rs.
Income from the activity of owning and maintaining race horses	75,000	
Less: Brought forward loss from the activity of owning and maintaining race horses	96,000	
Loss from the activity of owning and maintaining race horses to be carried forward to A.Y.2011-12	(21,000)	

Income from textile business	85,000	
Less: Brought forward business loss from textile business.	50,000	35,000
Taxable business income		**35,000**

Note: Loss from the activity of owning and maintaining race horses cannot be set-off against any other source/head of income.

10.14 CARRY FORWARD AND SET OFF OF LOSSES IN CASE OF CHANGE IN CONSTITUTION OF FIRM OR SUCCESSION [SECTION 78]

(i) Where there is a change in the constitution of a firm, so much of the loss proportionate to the share of a retired or deceased partner remaining unabsorbed, shall not be allowed to be carried forward by the firm. However, unabsorbed depreciation can be carried forward.

(ii) Where any person carrying on any business or profession has been succeeded in such capacity by another person otherwise than by inheritance, such other person shall not be allowed to carry forward and set off against his income, any loss incurred by the predecessor.

(iii) Where there is a succession by inheritance, the legal heirs (assessable as BOI) are entitled to set-off the business loss of the predecessor. Such carry forward and set-off is possible even if the legal heirs constitute themselves as a partnership firm. In such a case, the firm can carry forward and set-off the business loss of the predecessor.

10.15 CARRY FORWARD AND SET-OFF OF LOSSES IN CASE OF CLOSELY HELD COMPANIES [SECTION 79]

(i) Where in any previous year, there has been a change in the shareholding of a company in which the public are not substantially interested, any unabsorbed loss of the company shall be allowed to be carried forward and set off against the income of the previous year only if the beneficial shareholders of at least 51% of the voting power on the last day of the previous year remained the same as on the last day of the year or years in which the loss was incurred.

(ii) However, this restriction shall not apply in the following two cases:

(1) where a change in the voting power is consequent upon the death of a shareholder or on account of transfer of shares by way of gift by a shareholder to his relative; and

(2) where the change in shareholding takes place in an Indian company, being a subsidiary of a foreign company, as a result of amalgamation or demerger of the foreign company. However, this is subject to the condition that 51% of the shareholders of the amalgamating/demerged company continue to be shareholders of the amalgamated/resulting company.

(iii) The provisions of this section are applicable only in respect of carry forward of losses and not in respect of carry forward of unabsorbed depreciation, which is covered by section 32(2).

10.16 ORDER OF SET-OFF OF LOSSES

As per the provisions of section 72(2), brought forward business loss is to be set-off before setting off unabsorbed depreciation. Therefore, the order in which set-off will be effected is as follows -

(a) Current year depreciation / Current year capital expenditure on scientific research and current year expenditure on family planning, to the extent allowed.

(b) Brought forward loss from business/profession [Section 72(1)]

(c) Unabsorbed depreciation [Section 32(2)]

(d) Unabsorbed capital expenditure on scientific research [Section 35(4)].

(e) Unabsorbed expenditure on family planning [Section 36(1)(ix)]

Illustration 5

Mr. E has furnished his details for the A.Y.2010-11 as under:

Particulars	**Rs.**
Income from salaries	1,50,000
Income from speculation business	60,000
Loss from non-speculation business	(40,000)
Short term capital gain	80,000
Long term capital loss of A.Y.2008-09	(30,000)
Winning from lotteries	20,000

What is the taxable income of Mr. E for the A.Y. 2010-11?

Solution

Computation of taxable income of Mr. E for the A.Y.2010-11

Particulars	**Rs.**	**Rs.**
Income from salaries		1,50,000
Income from speculation business	60,000	
Less : Loss from non-speculation business	(40,000)	20,000
Short-term capital gain		80,000

Winnings from lotteries	20,000
Taxable income	**2,70,000**

Note: Long term capital loss can be set off only against long term capital gain. Therefore, long term capital loss of Rs.30,000 has to be carried forward to the next assessment year.

Illustration 6

Compute the Gross total income of Mr. F for the A.Y.2010-11 from the information given below

Particulars	Rs.
Net income from house property	1,25,000
Income from business (before providing for depreciation)	1,35,000
Short term capital gains on sale of shares	56,000
Long term capital loss from sale of property (brought forward from A.Y.2009-10)	(90,000)
Income from tea business	1,20,000
Dividends from Indian companies carrying on agricultural operations	80,000
Current year depreciation	26,000
Brought forward business loss (loss incurred six years ago)	(45,000)

Solution

The gross total income of Mr. F for the A.Y. 2010-11 is calculated as under:

Particulars	Rs.	Rs.
Income from house property		1,25,000
Income from business		
Profits before depreciation	1,35,000	
Less : current year depreciation	26,000	
Less : brought forward business loss	45,000	
	64,000	
Income from tea business (40% is business income)	48,000	1,12,000
Income from the capital gains		
Short term capital gains	56,000	
Long term capital loss from property (cannot be set off)	Nil	56,000
Gross Total Income		**2,93,000**

10.18 Income Tax

Note: Dividend from Indian companies is exempt from tax. 60% of the income from tea business is treated as agricultural income and therefore, exempt from tax.

Self-examination questions

1. Write short notes on -
   a) Inter-head adjustment
   b) Inter-source adjustment.
2. Discuss the correctness of the following statements -
   (i) Long term capital loss can be set-off against short-term capital gains arising in that year.
   (ii) Business loss can be set-off against salary income arising in that year.
3. Discuss briefly on -
   a) Carry forward and set-off of losses by closely held companies
   b) Set-off and carry forward of speculation business loss.
4. State the conditions to be fulfilled by an amalgamated company for carry forward of the accumulated loss and unabsorbed depreciation of the amalgamating company.
5. Discuss the provisions of the Income-tax Act, 1961 regarding set-off and carry forward of the following losses -
   a) Loss under the head "Capital Gains"
   b) Loss from the activity of owning and maintaining race horses.
6. What are the conditions to be fulfilled to carry-forward and set-off losses in the event of change in shareholding of a company in which public are not substantially interested? State the situations when the carry-forward and set-off is permissible without such restrictions.
7. Write a short note on carry forward and set-off of losses in case of -
   (a) change in constitution of firm;
   (b) succession by inheritance; and
   (c) succession otherwise than by inheritance.
8. Aditya, an Indian citizen who is about 70 years old, submits the following information for the previous year 2009-10:

Particulars	Rs.
Profit from leather goods business in Lucknow	5,00,000

Profit from textile export business in Chennai	6,00,000
Loss from wholesale business in Sri Lanka	8,50,000
Unabsorbed depreciation of wholesale business	70,000
Income from house property in Lucknow (computed)	1,10,000
Income from house property in Sri Lanka(computed)	80,000

The profits from wholesale business in Sri Lanka are received in the bank account in Sri Lanka. Rental income from the Sri Lanka property is also received there. Assuming that Aditya is a resident and ordinarily resident for P.Y.2009-10, compute the taxable income and tax payable by Aditya for the A.Y. 2010-11.

9. M/s. JKLM, a firm, consists of four partners namely, J, K, L and M. They shared profits and losses equally during the year ending 31.3.2009. The assessed business loss of the firm for the assessment year 2009-10 which it is entitled to carry forward amounts to Rs.3,60,000. A new deed of partnership was executed among J, K, L and M on 1.4.2009 in terms of which they agreed to share profits and losses in the ratio of 15:15:20:50 respectively.

   Compute the amount of business loss relating to the assessment year 2009-10, which the firm is entitled to set off against its business income for the assessment year 2010-11. The business income of the firm for the assessment year 2010-11 is Rs.3,30,000. Your answer should be supported by reasons.

10. An assessee sustained a loss under the head "Income from house property" in the previous year relevant to the assessment year 2009-10, which could not be set off against income from any other head in that assessment year. The assessee did not furnish the return of loss within the time allowed under section 139(1) in respect of the relevant assessment year. However, the assessee filed the return within the time allowed under section 139(4). Can the assessee carry forward such loss for set off against income from house property of the assessment year 2010-11?

Answers

9. The firm is entitled to set off its brought forward business loss amounting to Rs.3,60,000 relating to the A.Y. 2009-10 to the extent of Rs.3,30,000 against its business income of Rs.3,30,000 for the A.Y. 2010-11 as per the provisions of section 72(1). Section 78(1), which deals with carry forward and set-off of losses in case of change of constitution of firm, is applicable to cases where a partner has retired or died. The section is not applicable to a case where there is a change in the ratio of sharing profits and losses amongst the existing partners. Therefore, section 78(1) is not applicable to the case of M/s. JKLM. The unabsorbed business loss of Rs.30,000 relating to the A.Y. 2009-10 will

be carried forward for set-off against the business income for the A.Y. 2011-12.

10. Section 139(3) stipulates that an assessee claiming carry forward of loss under the heads "Profits and gains of business or profession" or "Capital gains" should furnish the return of loss within the time stipulated under section 139(1). There is no reference to loss under the head "Income from house property" in section 139(3). The assessee, in the instant case, has filed the return showing loss from property within the time prescribed under section 139(4). The assessee is, therefore, entitled to carry forward such loss for set off against the income from house property of the assessment year 2010-11.

11

DEDUCTIONS FROM GROSS TOTAL INCOME

11.1. GENERAL PROVISIONS

As we have seen earlier, section 10 exempts certain incomes. Such income are excluded from total income and do not enter into the computation process at all. On the other hand, Chapter VI-A contains deductions from gross total income. The important point to be noted here is that if there is no gross total income, then no deductions will be permissible. This Chapter contains deductions in respect of certain payments, deductions in respect of certain incomes and other deductions.

Section 80A

(i) Section 80A(1) provides that in computing the total income of an assessee, there shall be allowed from his gross total income, the deductions specified in sections 80C to 80U.

(ii) According to section 80A(2), the aggregate amount of the deductions under this chapter shall not, in any case, exceed the gross total income of the assessee. Thus, an assessee cannot have a loss as a result of the deduction under Chapter VI-A and claim to carry forward the same for the purpose of set-off against his income in the subsequent year.

(iii) Section 80A(3) provides that in the case of AOP/BOI, if any deduction is admissible under section 80G/80GGA/80GGC/80-IA/80-IB/80-IC/80-ID/80-IE, no deduction under the same section shall be made in computing the total income of a member of the AOP or BOI in relation to the share of such member in the income of the AOP or BOI.

(iv) The profits and gains allowed as deduction under section 10A or section 10AA or section 10B or under any provision of Chapter VIA under the heading "C.-Deductions in respect of certain incomes" in any assessment year, shall not be allowed as deduction under any other provision of the Act for such assessment year [Sub-section (4)];

(v) The deduction, referred to in (iv) above, shall not exceed the profits and gains of the undertaking or unit or enterprise or eligible business, as the case may be [Sub-section (4)];

(vi) No deduction under any of the provisions referred to in (iv) above, shall be allowed if the deduction has not been claimed in the return of income. [Sub-section (5)];

(vii) The transfer price of goods and services between such undertaking or unit or enterprise

or eligible business and any other business of the assessee shall be determined at the market value of such goods or services as on the date of transfer [Sub-section (6)].

(viii) For this purpose, the expression "market value" has been defined to mean,-

(a) in relation to any goods or services sold or supplied, the price that such goods or services would fetch if these were sold by the undertaking or unit or enterprise or eligible business in the open market, subject to statutory or regulatory restrictions, if any;

(b) in relation to any goods or services acquired, the price that such goods or services would cost if these were acquired by the undertaking or unit or enterprise or eligible business from the open market, subject to statutory or regulatory restrictions, if any.

Section 80AB

This section provides that for the purpose of calculation of deductions specified in Chapter VI-A under the heading "C - Deductions in respect of certain incomes", the net income computed in accordance with the provisions of the Act (before making any deduction under Chapter VI-A) shall alone be regarded as income received by the assessee and which is included in his gross total income. Accordingly, the deductions specified in the aforesaid sections will be calculated with reference to the net income as computed in accordance with the provisions of the Act (before making deduction under Chapter VI-A) and not with reference to the gross amount of such income. This is notwithstanding anything contained in the respective sections of Chapter VI-A.

Section 80AC - Furnishing return of income on or before due date mandatory for claiming exemption under sections 80-IA, 80-IAB, 80-IB, 80-IC, 80-ID and 80-IE

(i) Section 80AC stipulates compulsory filing of return of income on or before the due date specified under section 139(1), as a pre-condition for availing benefit under the following sections –

(1) Section 80-IA applicable to undertakings or enterprises engaged in infrastructure development, etc.

(2) Section 80-IAB applicable to undertakings or enterprises engaged in any business of developing a special economic zone.

(3) Section 80-IB applicable to certain industrial undertakings other than infrastructure development undertakings.

(4) Section 80-IC applicable to certain undertakings or enterprises in certain special category States.

(5) Section 80-ID applicable to undertakings engaged in the business of hotels and convention centres in specified area.

(6) Section 80-IE applicable to certain undertakings in North-Eastern States.

(ii) The effect of this provision is that in case of failure to file return of income on or before the stipulated due date, the undertakings would lose the benefit of deduction under these sections.

Section 80B(5)

"Gross total income" means the total income computed in accordance with the provisions of the Act without making any deduction under Chapter VI-A. "Computed in accordance with the provisions of the Act" implies—

(i) that deductions under appropriate computation section have already been given effect to;

(ii) that income of other persons, if includible under sections 60 to 64, has been included;

(iii) the intra head and/or inter head losses have been adjusted; and

(iv) that unabsorbed business losses, unabsorbed depreciation etc., have been set-off.

Let us first consider the deductions allowable in respect of certain payments.

11.2 DEDUCTIONS IN RESPECT OF PAYMENTS

11.2.1 Deduction in respect of investment in specified assets [Section 80C]

(i) Section 80C provides for a deduction from the Gross Total Income, of savings in specified modes of investments.

(ii) Deduction under section 80C is available only to an individual or HUF.

(iii) The maximum qualifying amount is Rs.1 lakh in respect of deductions under section 80C along with sections 80CCC (in respect of contribution to approved pension fund) and 80CCD (contribution to pension scheme of Central Government).

(iv) The following are the investments/contributions eligible for deduction –

(1) Premium paid on insurance on the life of the individual, spouse or child (minor or major) and in the case of HUF, any member thereof. This will include a life policy and an endowment policy. However, where the annual premium on insurance policies, other than a contract for deferred annuity , exceeds 20% of actual capital sum assured, only the amount of premium as does not exceed 20% will qualify for rebate.

For the purpose of calculating the actual capital sum assured under this clause,

(a) the value of any premiums agreed to be returned or

(b) the value of any benefit by way of bonus or otherwise, over and above the sum actually assured,

shall not be taken into account.

(2) Premium paid to effect and keep in force a contract for a deferred annuity on the life of the assessee and/or his or her spouse or child, provided such contract does not contain any provision for the exercise by the insured of an option to receive cash payments in lieu of the payment of the annuity.

It is pertinent to note here that a contract for a deferred annuity need not necessarily be with an insurance company. It follows therefore that such a contract can be entered into with any person.

11.4 Income Tax

(3) Amount deducted by or on behalf of the Government from the salary of a Government employee for securing a deferred annuity or making provisions for his spouse or children. The excess, if any, over one-fifth of the salary is to be ignored.

(4) Contributions to any provident fund to which the Provident Funds Act, 1925 applies.

(5) Contributions made to any Provident Fund set up by the Central Government and notified in his behalf (i.e., the Public Provident Fund established under the Public Provident Fund Scheme, 1968). Such contribution can be made in the name of any persons mentioned in (1) above.

(6) Contribution by an employee to a recognised provident fund.

(7) Contribution by an employee to an approved superannuation fund

(8) Subscription to any such security of the Central Government or any such deposit scheme as the Central Government as may notify in the Official Gazette.

(9) Subscription to any Savings Certificates under the Government Savings Certificates Act, 1959 notified by the Central Government in the Official Gazette (i.e. National Savings Certificate (VIII Issue) issued under the Government Savings Certificates Act, 1959).

(10) Contributions in the name of any person specified in (1) above for participation in the Unit-linked Insurance Plan 1971.

(11) Contributions in the name of any person mentioned in (1) above for participation in any Unit linked Insurance Plan of the LIC Mutual Fund, referred to in section 10(23D) in this behalf.

(12) Contributions to approved annuity plans of LIC (New Jeevan Dhara and New Jeevan Akshay, New Jeevan Dhara I and New Jeevan Akshay I, II and III) or any other insurer as the Central Government may, by notification in the Official Gazette, specify in this behalf.

(13) Subscription to any units of any mutual fund referred to in section 10(23D) or from the Administrator or the specified company under any plan formulated in accordance with such scheme notified by the Central Government;

(14) Contribution by an individual to a pension fund set up by any Mutual Fund referred to in section 10(23D) or by the Administrator or the specified company as the Central Government may specify (i.e. UTI-Retirement Benefit Pension Fund set up by the specified company referred to in section 2(h) of the Unit Trust of India (Transfer of Undertaking and Repeal) Act, 2002 as a pension fund).

For the purposes of (13) and (14) above –

(i) "Administrator" means the Administrator as referred to in clause (a) of section 2 of the Unit Trust of India (Transfer of Undertaking and Repeal) Act, 2002.

(ii) "specified company" means a company as referred to in clause (h) of section 2 of the Unit Trust of India (Transfer of Undertaking and Repeal) Act, 2002.

(15) Subscription to any deposit scheme or contribution to any pension fund set up by the National Housing Bank *i.e., National Housing Bank (Tax Saving) Term Deposit Scheme, 2008.*

(16) Subscription to any such deposit scheme of a public sector company which is engaged in providing long-term finance for construction, or purchase of houses in India for residential purposes or any such deposit scheme of any authority constituted in India by or under any law enacted either for the purpose of dealing with and satisfying the need for housing accommodation or for the purpose of planning, development or improvement of cities, towns and villages or for both. The deposit scheme should be notified by the Central Government. The Central Government has, vide Notification No.2/2007 dated 11.1.2007, specified the public deposit scheme of HUDCO, subscription to which would qualify for deduction under section 80C.

(17) Payment of tuition fees by an individual assessee at the time of admission or thereafter to any university, college, school or other educational institutions within India for the purpose of full-time education of any two children of the individual. This benefit is only for the amount of tuition fees for full-time education and shall not include any payment towards development fees or donation or payment of similar nature and payment made for education to any institution situated outside India.

(18) Any payment made towards the cost of purchase or construction of a new residential house property. The income from such property –

(i) should be chargeable to tax under the head "Income from house property";

(ii) would have been chargeable to tax under the head "Income from house property" had it not been used for the assessee's own residence.

The approved types of payments are as follows :

(i) Any installment or part payment of the amount due under any self-financing or other schemes of any development authority, Housing Board or other authority engaged in the construction and sale of house property on ownership basis; or

(ii) Any installment or part payment of the amount due to any company or a cooperative society of which the assessee is a shareholder or member towards the cost of house allotted to him; or

(iii) Repayment of amount borrowed by the assessee from:

(a) The Central Government or any State Government ;

(b) Any bank including a co-operative bank ;

(c) The L.I.C. ;

(d) The National Housing Bank ;

(e) Any 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 which is eligible for deduction under section 36(1)(viii).

(f) Any company in which the public are substantially interested or any cooperative society engaged in the business of financing the construction of houses.

(g) The assessee's employer, where such employer is an authority or a board or a corporation or any other body established or constituted under a Central or State Act;

(h) the assessee's employer where such employer is a public company or public sector company or a university established by law or a college affiliated to such university or a local authority or a co-operative society.

(iv) Stamp duty, registration fee and other expenses for the purposes of transfer of such house property to the assessee.

Inadmissible payments : However, the following amounts do not qualify for rebate:

(i) admission fee, cost of share and initial deposit which a shareholder of a company or a member of a co-operative society has to pay for becoming a shareholder or member; or

(ii) the cost of any addition or alteration or renovation or repair of the house property after the completion of the house or after the house has been occupied by the assessee or any person on his behalf or after it has been let out; or

(iii) any expenditure in respect of which deduction is allowable under section 24.

(19) Subscription to equity shares or debentures forming part of any eligible issue of capital approved by the Board on an application made by a public company or as subscription to any eligible issue of capital by any public financial institution in the prescribed form.

Eligible issue of capital means an issue made by a public company formed and registered in India or a public financial institution and the entire proceeds of the issue are utilised wholly and exclusively for the purposes of any business referred to in section 80-IA(4).

A lock-in period of three years is provided in respect of such equity shares or debentures. In case of any sale or transfer of shares or debentures within three years of the date of acquisition, the aggregate amount of deductions allowed in respect of such equity shares or debentures in the previous year or years preceding the previous year in which such sale or transfer has taken place shall be deemed to be the income of the assessee of such previous year and shall be liable to tax in the assessment year relevant to such previous year.

A person shall be treated as having acquired any shares or debentures on the date on which his name is entered in relation to those shares or debentures in the register of members or of debenture-holders, as the case may be, of the public company.

(20) Subscription to any units of any mutual fund referred to in section 10(23D)] and approved by the Board on an application made by such mutual fund in the prescribed form.

It is necessary that the subscription to such units should be subscribed only in the eligible issue of capital of any company.

(21) Investment in term deposit

(1) for a period of not less than five years with a scheduled bank; and

(2) which is in accordance with a scheme framed and notified by the Central Government in the Official Gazette

now qualifies as an eligible investment for availing deduction under section 80C.

Scheduled bank means -

(1) the State Bank of India constituted under the State Bank of India Act, 1955, or

(2) a subsidiary bank as defined in the State Bank of India (Subsidiary Banks) Act, 1959, or

(3) a corresponding new bank constituted under section 3 of the -

(a) Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970, or

(b) Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980, or

(4) any other bank, being a bank included in the Second Schedule to the Reserve Bank of India Act, 1934.

(22) Subscription to such bonds issued by NABARD (as the Central Government may notify in the Official Gazette).

(23) five year time deposit in an account under Post Office Time Deposit Rules, 1981; and

(24) deposit in an account under the Senior Citizens Savings Scheme Rules, 2004.

Termination of Insurance Policy or Unit Linked Insurance Plan or transfer of House Property or withdrawal of deposit:

Where, in any previous year, an assessee :

(i) terminates his contract of insurance referred to in (1) above, by notice to that effect or where where the contract ceases to be in force by reason of not paying the premium, by not reviving the contract of insurance, -

(a) in case of any single premium policy, within two years after the date of commencement of insurance; or

(b) in any other case, before premiums have been paid for two years; or

(ii) terminates his participation in any Unit Linked Insurance Plan referred to in (10) or (11) above, by notice to that effect or where he ceases to participate by reason of failure to pay any contribution, by not reviving his participation, before contributions in respect of such participation have been paid for five years, or

(iii) transfers the house property referred to in (18) above, before the expiry of five years from the end of the financial year in which possession of such property is obtained by him, or receives back, whether by way of refund or otherwise, any sum specified in (18) above,

then, no deduction will be allowed to the assessee in respect of sums paid during such previous year and the total amount of deductions of income allowed in respect of the previous year or years preceding such previous year, shall be deemed to be income of the assessee of such previous year and shall be liable to tax in the assessment year relevant to such previous year.

Further, where any amount is withdrawn by the assessee from his account under the Senior Citizens Savings Scheme or under the Post Office Time Deposit Rules before the expiry of a period of 5 years from the date of its deposit, the amount so withdrawn shall be deemed to be the income of the assessee of the previous year in which the amount is withdrawn. Accordingly, the amount so withdrawn would be chargeable to tax in the assessment year relevant to such previous year. The amount chargeable to tax shall would also include that part of the amount withdrawn which represents interest accrued on the deposit. However, if any part of the amount so received or withdrawn (including the amount relating to interest) has been subject to tax in any of the earlier years, such amount shall not be taxed again.

Illustration 1

Mr. A, aged about 66 years, has earned a lottery income of Rs.1,20,000 (gross) during the P.Y. 2009-10. He also has a business income of Rs.30,000. He invested an amount of Rs.10,000 in Public Provident Fund account and Rs.24,000 in National Saving Certificates. What is the total taxable income of Mr. A for the A.Y.2010-11?

Solution

Computation of total taxable income of Mr. A for A.Y.2010-11

Particulars	Rs.	Rs.
Profits and gains from business or profession		30,000
Income from other sources - lottery income		1,20,000
Gross Total Income		**1,50,000**
Less: Deductions under Chapter VIA [See Note below]		
Under section 80C - Deposit in Public Provident Fund	10,000	
- Investment in National Saving Certificate	24,000	
	34,000	
Restricted to		30,000
Total Income		**1,20,000**

Note: Though the value of eligible investments is Rs.34,000, however, deductions under chapter VIA cannot exceed the Gross Total Income exclusive of Long Term Capital Gain, Short Term Capital Gain covered under section 111A, winnings of lotteries etc of the assessee.

Therefore maximum permissible deduction under section 80C = Rs.1,50,000 – Rs.1,20,000 = Rs.30,000

Illustration 2

An individual assessee, resident in India, has made the following investments during the previous year 2009-10 :

Particulars	Rs.
Contribution to the public provident fund	50,000
Investment in units of eligible mutual funds	40,000
Insurance premium paid on the life of the spouse (Assured value Rs.1,00,000)	25,000

What is the deduction allowable under section 80C for A.Y.2010-11?

Solution

Computation of deduction under section 80C for A.Y.2010-11

Particulars	Rs.
Deposit in public provident fund	50,000
Investment in units of mutual funds	40,000
Insurance premium paid on the life of the spouse (Maximum 20% of the assured value Rs.1,00,000)	20,000
Total	1,10,000
However, the maximum permissible deduction is restricted to	1,00,000

Note: As per section 80CCE, total deduction under section 80C, 80CCC and 80CCD cannot exceed Rs.1,00,000

11.2.2 Deduction in respect of contribution to certain pension funds [Section 80CCC]

(i) Where an assessee, being an individual, has in the previous year paid or deposited any amount out of his income chargeable to tax to effect or keep in force a contract for any annuity plan of LIC of India or any other insurer for receiving pension from the fund referred to in clause (23AAB) of section 10, he shall be allowed a deduction in the computation of his total income.

(ii) For this purpose, the interest or bonus accrued or credited to the assessee's account shall not be reckoned as contribution.

(iii) The maximum permissible deduction is Rs.1,00,000 (However, the overall limit of Rs.1,00,000 prescribed in section 80CCE will continue to be applicable i.e. the maximum permissible deduction under sections 80C, 80CCC and 80CCD put together is Rs.1,00,000).

(iv) Where any amount standing to the credit of the assessee in a fund referred to in clause (23AAB) of section 10 in respect of which a deduction has been allowed, together with interest or bonus accrued or credited to the assessee's account is received by the assessee or his nominee on account of the surrender of the annuity plan in any previous year or as pension received from the annuity plan, such amount will be deemed to be the income of the assessee or the nominee in that previous year in which such withdrawal is made or pension is received. It will be chargeable to tax as income of that previous year.

(v) Where any amount paid or deposited by the assessee has been taken into account for the purposes of this section, a deduction under section 80C shall not be allowed with reference to such amount.

11.2.3 Deduction in respect of contribution to pension scheme of Central Government [Section 80CCD]

(i) A "New Restructured Defined Contribution Pension System" applicable to new entrants to Government service has been introduced. As per the scheme, it is mandatory for persons entering the service of the Central Government on or after 1st January, 2004, to contribute ten per cent their of salary every month towards their pension account. A matching contribution is required to be made by the Government to the said account. The benefit of this scheme is available to individuals employed by any other employer also on or after 1st January, 2004.

(ii) To give effect to the new pension scheme of the Central Government, a new section 80CCD has been inserted.

(iii) This section provides a deduction for the amount paid or deposited by an employee in his pension account subject to a maximum of 10% of his salary.

(iv) The contribution made by the Central Government or any other employer in the previous year to the said account of an employee, is allowed as a deduction in computation of the total income of the assessee. However, the deduction is restricted to 10% of the employee's salary.

(v) The entire employer's contribution would be included in the salary of the employee. However, deduction under section 80CCD would be restricted to 10% of salary.

(vi) This deduction is now extended also to self-employed individuals. The deduction in the case of a self-employed individual would be restricted to 10% of his gross total income in the previous year.

(vii) Further, the amount standing to the credit of the assessee in the pension account (for which deduction has already been claimed by him under this section) and accretions to such account, shall be taxed as income in the year in which such amounts are received by the assessee or his nominee on -

(a) closure of the account or

(b) his opting out of the said scheme or

(c) receipt of pension from the annuity plan purchased or taken on such closure or opting out.

(viii) However, the assessee shall be deemed not to have received any amount in the previous year if such amount is used for purchasing an annuity plan in the same previous year.

(ix) No deduction will be allowed under section 80C in respect of amounts paid or deposited by the assessee, for which deduction has been allowed under section 80CCD(1).

11.2.4 Limit on deductions under sections 80C, 80CCC & 80CCD [Section 80CCE]

This section restricts the aggregate amount of deduction under section 80C, 80CCC and 80CCD to Rs.1 lakh.

11.2.5 Deduction in respect of medical insurance premium [Section 80D]

(i) Deduction is allowed under section 80D up to a maximum of Rs.15,000 to an individual in respect of medical insurance premium paid for self, spouse and dependent children.

(ii) An additional deduction of up to Rs.15,000 would be allowed to an individual in respect of medical insurance premium paid for insuring the health of a parent or parents. This would be in addition to the deduction of Rs.15,000 in respect of medical insurance premium paid for self, spouse and dependent children. Such additional deduction would be available even if the parents are not dependent on the individual.

(iii) In case the sum is paid to insure the health of a senior citizen, then the deduction would be Rs.20,000 instead of Rs.15,000.

(iv) In case of an individual, the maximum deduction allowable under this section would, therefore, be Rs.30,000 [i.e. Rs.15,000 + Rs.15,000] and in case any of the persons insured is a senior citizen, Rs.35,000 [i.e. Rs.15,000 + Rs.20,000].

For example, if Mr. Ganesh pays medical insurance premium of Rs.16,000 for insuring the health of himself, his spouse and his children and Rs.21,000 for insuring the health of his parents, then he would be eligible for a deduction of Rs.30,000 [Rs.15,000 + Rs.15,000] under section 80D, whether or not his parents are dependent on him. If either or both of his parents are senior citizens, then he would be entitled to a higher deduction of Rs.35,000 [Rs.15,000 + Rs.20,000].

(v) In the case of a HUF, deduction is allowed under this section in respect of premium paid to insure the health of any member of the family. The maximum deduction available to a HUF would be Rs.15,000 and in case any member is a senior citizen, Rs.20,000.

(vi) The other conditions to be fulfilled are that such premium should be paid by any mode, other than cash, in the previous year out of his income chargeable to tax. Further,

the medical insurance should be in accordance with a scheme made in this behalf by -

(a) the General Insurance Corporation of India and approved by the Central Government in this behalf; or

(b) any other insurer and approved by the Insurance Regulatory and Development Authority.

11.2.6 Deduction in respect of maintenance including medical treatment of a dependent disabled [Section 80DD]

(i) Section 80DD provides deduction to an assessee, who is a resident in India, being an individual or Hindu undivided family. Any amount paid for the medical treatment (including nursing), training and rehabilitation of a dependant, being a person with disability, or any amount paid or deposited under a scheme framed in this behalf by the Life Insurance Corporation or any other insurer or the Administrator or the Specified Company as referred to in section 2(h) of the Unit Trust of India (Transfer of Undertaking and Repeal) Act, 2002, for the maintenance of a dependant, being a person with disability, qualifies for deduction.

(ii) The benefit of deduction under this section is also available to assessees incurring expenditure on maintenance including medical treatment of persons suffering from autism, cerebral palsy and multiple disabilities.

(iii) The quantum of deduction is Rs.50,000 and in case of severe disability (i.e. person with 80% or more disability) the deduction shall be *Rs.1,00,000*.

(iv) The term 'dependent' has been defined to include in the case of an individual, the spouse, children, parents, brothers and sisters of the individual and in the case of a Hindu Undivided Family (HUF), a member thereof, who is wholly or mainly dependent on the assessee and has not claimed any deduction under section 80U in the computation of his income.

(v) For claiming the deduction, the assessee shall have to furnish a copy of the certificate issued by the medical authority under the Persons with Disability (Equal Opportunities, Protection of Rights and Full Participation) Act, 1995 along with the return of income under section 139.

(vi) Where the condition of disability requires reassessment, a fresh certificate from the medical authority shall have to be obtained after the expiry of the period mentioned in the original certificate in order to continue to claim the deduction.

Illustration 3

Mr. X is a resident individual. He deposits a sum of Rs.25,000 with Life Insurance Corporation every year for the maintenance of his handicapped grandfather who is wholly dependent upon him. The disability is one which comes under the Persons with Disabilities (Equal Opportunities, Protection of Rights and Full Participation) Act, 1995. A copy of the certificate from the medical authority is submitted. Compute the amount of deduction available under section 80DD for the A.Y. 2010-11.

Solution

Since the amount deposited by Mr. X was for his grandfather, he will not be allowed any deduction under section 80DD. The deduction is available if the individual assessee incurs any expense for a dependant disabled relative. Grandfather does not come within the definition of dependant relative.

Illustration 4

What will be the deduction if Mr. X had made this deposit for his dependant father?

Solution

Since the expense was incurred for a dependant disabled relative, Mr. X will be entitled to claim a deduction of Rs.50,000 under section 80DD, irrespective of the amount deposited. In case his father has severe disability, the deduction would be *Rs.1,00,000.*

11.2.7 Deduction in respect of medical treatment etc. [Section 80DDB]

(i) This section provides deduction to an assessee, who is resident in India, being an individual and Hindu undivided family. Any amount actually paid for the medical treatment of such disease or ailment as may be specified in the rules made in this behalf by the Board for himself or a dependent, in case the assessee is an individual or for any member of a HUF, in case the assessee is a HUF will qualify for deduction.

(ii) The amount of deduction under this section shall be equal to the amount actually paid or Rs.40,000, whichever is less, in respect of that previous year in which such amount was actually paid. In case the amount is paid in respect of a senior citizen, then the deduction would be the amount actually paid or Rs.60,000, whichever is less.

(iii) The term 'dependent' includes in the case of an individual, the spouse, children, parents, brothers and sisters of the individual and in the case of a Hindu undivided family (HUF), a member of the HUF, who is wholly or mainly dependent on such individual or HUF for his support and maintenance.

(iv) No such deduction shall be allowed unless the assessee furnishes with a return of income, a certificate in such form, as may be prescribed, from a neurologist, an oncologist, a urologist, a hematologist, an immunologist or such other specialist, as may be prescribed, working in a Government hospital.

(v) The term "Government hospital" will also include approved hospitals for the treatment of Government servants.

(vi) The deduction under this section shall be reduced by the amount received, if any, under an insurance from an insurer, or reimbursed by an employer, for the medical treatment of the assessee or the dependent.

11.2.8 Deduction in respect of interest loan taken for higher education [Section 80E]

(i) Section 80E provides deduction to an individual-assessee in respect of any interest on loan paid by him in the previous year out of his income chargeable to tax.

(ii) The loan must have been taken for the purpose of pursuing his higher education or for the purpose of higher education of his or her relative i.e. spouse or children of the individual *or the student for whom the individual is the legal guardian.*

(iii) "Higher education" means any course of study (including vocational studies) pursued after passing the Senior Secondary Examination or its equivalent from any school, board or university recognised by the Central Government or State Government or local authority or by any other authority authorized by the Central Government or State Government or local authority to do so. Therefore, interest on loan taken for pursuing any course after Class XII or its equivalent, will qualify for deduction under section 80E.

(iv) The loan must have been taken from any financial institution or approved charitable institution.

(v) The deduction is allowed in computing the total income in respect of the initial assessment year (i.e. the assessment year relevant to the previous year, in which the assessee starts paying the interest on the loan) and seven assessment years immediately succeeding the initial assessment year or until the interest is paid in full by the assessee, whichever is earlier.

(vi) "Approved charitable institution" means an institution established for charitable purposes and approved by the prescribed authority under section 10(23C) or an institution referred to in section 80G(2)(a).

(vii) "Financial institution" means –

(1) a banking company to which the Banking Regulation Act, 1949 applies (including a bank or banking institution referred to in section 51 of the Act); or

(2) any other financial institution which the Central Government may, by notification in the Official Gazette, specify in this behalf.

Illustration 5

Mr. B has taken three education loans on April 1, 2009, the details of which are given below:

	Loan 1	Loan 2	Loan 3
For whose education loan was taken	B	Son of B	Daughter of B
Purpose of loan	MBA	B. Sc.	B.A.
Amount of loan (Rs.)	5,00,000	2,00,000	4,00,000
Annual repayment of loan (Rs.)	1,00,000	40,000	80,000
Annual repayment of interest (Rs.)	20,000	10,000	18,000

Compute the amount deductible under section 80E for the A.Y.2010-11.

Solution

Deduction under section 80E is available to an individual assessee in respect of any interest paid by him in the previous year in respect of loan taken for pursuing his higher education or higher education of his spouse or children. Higher education means any course of study pursued after senior secondary examination.

Therefore, interest repayment in respect of all the above loans would be eligible for deduction.

Deduction under section 80E = Rs.20,000 + Rs.10,000 + Rs.18,000 = Rs.48,000

11.2.9 Deduction in respect of donations to certain Funds, Charitable Institutions etc. [Section 80G]

(i) Where an assessee pays any sum as donation to eligible funds or institutions, he is entitled to a deduction, subject to certain limitations, from the gross total income.

(ii) The following table gives the details of the institutions and funds to which donations can be made for the purpose of claiming deduction under section 80G, the qualifying amount and the deductions allowable -

Eligible institutions / funds		Permissible deduction
1		2
1.	The National Defence Fund set up by the Central Government.	100%
2.	The Jawaharlal Nehru Memorial Fund.	50%
3.	Prime Minister's Drought Relief Fund.	50%
4.	Prime Minister's National Relief Fund.	100%
5.	Prime Minister's Armenia Earthquake Relief Fund.	100%
6.	The Africa (Public Contributions-India) Fund.	100%
7.	The National Children's Fund.	50%
8.	Indira Gandhi Memorial Trust.	50%
9.	Rajiv Gandhi Foundation.	50%
10.	The National Foundation for Communal Harmony.	100%
11.	Approved University or educational institution of national eminence.	100%
12.	Maharashtra Chief Minister's Earthquake Relief Fund.	100%
13.	Any fund set up by the State Government of Gujarat exclusively for providing relief to the victims of the Gujarat earthquake.	100%
14.	Any Zila Saksharta Samiti for primary education in villages and towns and for literacy and post-literacy activities	100%
15.	National Blood Transfusion Council or any State Blood Transfusion Council whose sole objective is the control, supervision, regulation or	

	encouragement of operation and requirements of blood banks.	100%
16.	Any State Government Fund set up to provide medical relief to the poor.	100%
17.	The Army Central Welfare Fund or Indian Naval Benevolent Fund or Air Force Central Welfare Fund established by the armed forces of the Union for the welfare of past and present members of such forces or their dependents.	100%
18.	The National Illness Assistance Fund.	100%
19.	The Chief Minister's Relief Fund or Lieutenant Governor's Relief Fund.	100%
20.	The National Sports Fund set up by the Central Government.	100%
21.	The National Cultural Fund set up by the Central Government.	100%
22.	The Fund for Technology Development and Application set up by the Central Government.	100%
23.	National Trust for welfare of persons with Autism, Cerebral Palsy, Mental Retardation and Multiple Disabilities.	100%
24.	Any Institution or Fund established in India for charitable purposes fulfilling certain prescribed conditions under section 80G(5)	50% subject to qualifying limit
25.	The Government or any local authority for utilisation for any charitable purpose other than the purpose of promoting family planning.	50% subject to qualifying limit
26.	An authority constituted in India or under any other law enacted either for dealing with and satisfying the need for	

	housing accommodation or for the purpose of planning, development or improvement of cities, towns and villages, or both.	50% subject to qualifying limit
27.	Any Corporation established by the Central Government or any State Government for promoting the interests of the members of a minority community.	50% subject to qualifying limit
28.	The Government or to any approved local authority, institution or association for promotion of family planning.	100% subject to qualifying limit
29.	Notified temple, mosque, gurdwara, church or other place of historic, archaeological or artistic importance or which is a place of public worship of renown throughout any State or States.	50% subject to qualifying limit
30.	Sum paid by a company as donation to the Indian Olympic Association or any other association/institution established in India, as may be notified by the Government for the development of infrastructure for sports or games, or the sponsorship of sports and games in India.	100% subject to qualifying limit

(iii) The conditions mentioned in item No. 24 above are as follows:

(1) The institution or fund is:

(a) constituted as a public charitable trust, or

(b) registered under the Societies Registration Act, 1960 or under any corresponding law or under section 25 of the Companies Act, 1956, or

(c) a University established by law or

(d) any other educational institution recognized by the Government or

(e) an institution financed wholly or in part by the Government or a local authority.

(2) Where such Institution or Fund derives any income, such income should not be liable

to inclusion in its total income under the provisions of section 10(23AA), 10(23C) or 11 or 12.

The Institution, referred to in the above clauses of section 10 are as follows :

(i) Regimental fund or Non-public Fund established by the armed forces of the Union for the welfare of its members and their dependants [Section 10(23AA)]

(ii) The Prime Minister Fund (Promotion of Folk Art) [Section 10(23C)]

(iii) The Prime Minister Aid to Students Fund [Section 10(23C)]

(iv) National Foundation for communal harmony [Section 10(23C)]

(v) Charitable Trusts and Institutions [Sections 11 and 12].

However, it may be noted that the assessee will not lose the benefit of deduction if :

(a) subsequent to the donation, any part of the income of the Institution has become chargeable to tax due to non-compliance with any of the provisions of section 11 or 12 or 12A.

(b) as a result of the operation of section 11(1)(*c*), exemption under section 11 or 12 is denied to the institution.

(3) No part of the income or assets of the Institution or Fund is transferable or applicable at any time for any purposes other than charitable purpose. Such charitable purpose however does not include any purpose the whole or substantially the whole of which is of a religious nature.

For the purposes of this section, an association or institution having as its object the control, supervision, regulation or encouragement in India of such games or sports as the Central Government may, by notification in the Official Gazette, specify in this behalf, shall be deemed to be an institution established in India for a charitable purpose.

(4) The Institution or Fund is not expressed to be for the benefit of any particular religious community or caste. An institution or fund established for the benefit of women and children or of Scheduled Castes, Backward classes or Scheduled Tribes is not however to be treated as an institution or fund for the benefit of a religious community or caste.

(5) The Institution or Fund maintains regular accounts of its receipt and expenditure.

(iv) Section 80G(4) clarifies that the limits prescribed therein will apply with reference to aggregate amount of donations qualifying for deduction and not with reference to the quantum of deduction admissible. For applying the qualification limit, all the eligible donations should be aggregated and the sum total should be limited to 10% of the adjusted gross total income. The excess shall be ignored in computing the aggregate in respect of which deduction is allowable.

Adjusted gross total income means the gross total income as reduced by the following:

(1) amount of deductions under sections 80C to 80U (but not including section 80G),

(2) Any income on which income tax is not payable,

(3) Long term capital gains and

(4) Income referred to in sections 115A, 115AB,115AC, 115AD, 115BB and 115D.

(v) Where an assessee has claimed and has been allowed any deduction under this section in respect of any amount of donation, the same amount will not qualify for deduction under any other provision of the Act for the same or any other assessment year [Sub-section (5A)].

(vi) Where an institution or fund incurs expenditure of a religious nature for an amount not exceeding 5% of its total income in that previous year, such institution or fund shall be deemed to be a fund or institution to which the provisions of this section apply [Sub-section (5B)].

(vii) Donations in kind shall not qualify for deduction.

(viii) The deduction under section 80G can be claimed whether it has any nexus with the business of the assessee or not.

(ix) In respect of donations made after 31.3.1992 to any institution or fund, such institution or fund must be approved by the Commissioner in accordance with the rules made in this behalf.

(x) As per Circular No.2/2005 dated 12.1.2005, in cases where employees make donations to the Prime Minister's National Relief Fund, the Chief Minister's Relief Fund or the Lieutenant Governor's Relief Fund through their respective employers, it is not possible for such funds to issue separate certificate to every such employee in respect of donations made to such funds as contributions made to these funds are in the form of a consolidated cheque. An employee who makes donations towards these funds is eligible to claim deduction under section 80G. It is, hereby, clarified that the claim in respect of such donations as indicated above will be admissible under section 80G of the Income-tax Act, 1961 on the basis of the certificate issued by the Drawing and Disbursing Officer(DDO)/Employer in this behalf.

11.2.10 Deduction in respect of rent paid [Section 80GG]

(i) This section provides for deduction in respect of rent paid.

(ii) The following conditions have to be satisfied for claiming deduction under section 80GG -

(1) The assessee should not be receiving any house rent allowance exempt under section 10(13A).

(2) The expenditure incurred by him on rent of any furnished or unfurnished accommodation should exceed 10% of his total income arrived at after all deductions under Chapter VI A except section 80GG.

(3) The accommodation should be occupied by the assessee for the purposes of his own residence.

(4) The assessee should fulfil such other conditions or limitations as may be prescribed, having regard to the area or place in which such accommodation is situated and other relevant considerations.

(5) The assessee or his spouse or his minor child or an HUF of which he is a member should

not own any accommodation at the place where he ordinarily resides or perform duties of his office or employment or carries on his business or profession; or

(6) If the assessee owns any accommodation at any place other than that referred to above, such accommodation should not be in the occupation of the assessee and its annual value is not required to be determined under section 23(2)(a) or section 23(4)(a).

(7) The assessee should file a declaration in Form 10BA, confirming the details of rent paid and fulfillment of other conditions, with the return of income.

(iii) The deduction admissible will be the least of the following:

(1) Actual rent paid minus 10% of the total income of the assessee before allowing the deduction, or

(2) 25% of such total income (arrived at after making all deductions under Chapter VI A but before making any deduction under this section), or

(3) Amount calculated at Rs.2,000 p.m.

Total income for the above purpose will not include long term capital gains, if any, and any income referred to in sections 115A to 115D.

Illustration 6

An assessee, whose total income is Rs.46,000, paid house rent at Rs.1,200 p.m. in respect of residential accommodation occupied by him at Mumbai. Compute the deduction allowable under section 80GG.

Solution

The deduction under section 80GG will be computed as follows:

(i) Actual rent less 10 per cent of total income

$$14{,}400 \text{ minus } \frac{(10 \times 46{,}000)}{100} = \text{Rs.}9{,}800(A)$$

(ii) 25 per cent of total income

$$\frac{25 \times 46{,}000}{100} = \text{Rs.}11{,}500(B)$$

(iii) Amount calculated at Rs.2,000 p.m.= Rs.24,000(C)

Deduction allowable (least of A, B and C) = Rs.9,800

11.2.11 Deduction in respect of donations for scientific research and rural development [Section 80GGA]

(i) Section 80GGA grants deduction in respect of the donations made for scientific research or rural development by any not having income chargeable under the head “Profits and gains

of business or profession".

(ii) The following donations would qualify for deduction under this section -

(1) Any sum paid by the assessee in the previous year to a scientific research association which has, as its object, the undertaking of scientific research or to a University, college or other institution to be used for scientific research; and

(2) Any sum paid by the assessee in the previous year to an association or institution which has as its object the undertaking of any programme of rural development to be used for carrying out any programme of rural development approved by the prescribed authority for purposes of section 35CCA or to an institution or association which has as its object the training of persons for implementing programmes of rural development.

It is, however, essential that in respect of both the aforesaid donations, the association or institution to which the donation is given must be approved by the prescribed authority; in the case of donation for scientific research, the donation must be to the institution approved under section 35(1)(ii) whereas in the case of donation for rural development the institution or association must be approved by the prescribed authority under section 35CCA(2) of the Income-tax Act.

(3) Any sum paid to a University, College or other institution to be used for research in social science or statistical research.

Such University, College or institution must be approved under section 35(1)(iii).

(4) Any sum paid to a public sector company or a local authority or to an association or institution approved by the National Committee for carrying out any eligible project or scheme.

However, the assessee must furnish a certificate referred to in section 35AC from such public sector company or local authority or association or institution.

The expression "National Committee" and "eligible project or scheme" shall have the meanings respectively assigned to them in the Explanation to section 35AC.

Note – It has been clarified that the deduction to which an assessee is entitled in respect of any sum paid to a scientific research association, university, college or other institution or to an association or institution for carrying out the programme of rural development, or to a public sector company, or to a local authority or to an association or institution for carrying out the eligible project or scheme referred to in section 35AC, respectively, shall not be denied merely on the ground that subsequent to the payment of such sum by the assessee the approval granted or, as the case may be, the notification has been withdrawn.

(5) Any sum paid to a rural development fund set up and notified under section 35CCA.

(6) Any sum paid by the assessee in the previous year to National Urban Poverty Eradication Fund (NUPEF).

(iii) Restrictions on deduction -

(1) No deduction under this section would be allowed in the case of an assessee whose gross total income includes income which is chargeable under the head "Profits and gains of business or profession."

(2) Where a deduction under this section is claimed and allowed for any assessment year, deduction shall not be allowed in respect of such payment under any provision of this Act for the same or any other assessment year.

11.2.12 Deduction in respect of contributions given by companies to political parties [Section 80GGB]

(i) This section provides for deduction of any sum contributed in the previous year by an Indian company to any political party *or an electoral trust.*

(ii) For the purposes of this section, the word "contribute" has the same meaning assigned to it under section 293A of the Companies Act, 1956, which provides that -

(a) a donation or subscription or payment given by a company to a person for carrying on any activity which is likely to effect public support for a political party shall also be deemed to be contribution for a political purpose;

(b) the expenditure incurred, directly or indirectly, by a company on advertisement in any publication (being a publication in the nature of a souvenir, brochure, tract, pamphlet or the like) by or on behalf of a political party or for its advantage shall also be deemed to be a contribution to such political party or a contribution for a political purpose to the person publishing it.

(iii) "Political party" means a political party registered under section 29A of the Representation of the People Act, 1951.

11.2.13 Deduction in respect of contributions given by any person to political parties [Section 80GGC]

(i) This section provides for deduction of any sum contributed in the previous year by any person to a political party *or an electoral trust.*

(ii) However, the deduction will not be available to a local authority and an artificial juridical person, wholly or partly funded by the Government.

(iii) "Political party" means a political party registered under section 29A of the Representation of the People Act, 1951.

11.3 DEDUCTION IN RESPECT OF INCOMES

11.3.1 Deductions in respect of profits and gains from undertakings or enterprises engaged in infrastructure development, etc. [Section 80-IA]

(i) Applicability

Section 80-IA(1) provides a ten year tax holiday to an assessee, whose gross total income includes any profits and gains derived by an undertaking or enterprise from an eligible

business i.e., business referred to in sub-section (4), namely :

(1) Infrastructure facility - Any enterprise carrying on the business of :

(a) developing

(b) operating and maintaining; or

(c) developing, operating and maintaining any infrastructure facility.

Conditions: However, such enterprise must fulfil the following conditions :

(i) It must be owned by a company registered in India or by a consortium of such companies or by an authority or a board or a corporation or any other body established or constituted under any Central or State Act.

(ii) It has entered into an agreement with the Central or a State Government or a local authority or statutory body for (i) developing or (ii) operating and maintaining, or (iii) developing, operating and maintaining a new infrastructure facility.

(iii) It starts operating and maintaining such infrastructure facility on or after 1-4-1995.

(iv) However, where an enterprise which developed such infrastructure facility transfers it to another enterprise on or after 1-4-1999, and such transferee enterprise operates and maintains it according to the agreement drawn up with the Government, etc., this section will apply to the transferee enterprise for the unexpired period of deduction (which was available to the first enterprise).

Meaning of "infrastructure facility": For this purpose, 'infrastructure facility' means :

(i) a road, including toll road, a bridge or a rail system;

(ii) a highway project including housing or other activities being an integral part of the highway project;

(iii) a water supply project, water treatment system, irrigation project, sanitation and sewerage system or solid waste management system; and

(iv) a port, airport, inland waterway or inland port or navigational channel in the sea.

Note – 1. Structures at the ports for storage, loading and unloading etc. will be included in the definition of port for the purpose of section 80-IA, if the concerned port authority has issued a certificate that the said structures form part of the port.

2. Effluent treatment and conveyance system is a part of water treatment system and would accordingly, qualify as an infrastructure facility for the purpose of section 80-IA.

(2) Telecom undertakings : Any undertaking providing telecommunication services, whether basic or cellular, including radio paging, domestic satellite service or network of trunking (NOT), broadband network and internet services on or after 1 April, 1995 but on or before 31 March, 2005.

Meaning of "domestic satellite": 'Domestic satellite' has been defined by sub-section (12)(a) as "a satellite owned and operated by an Indian company for providing telecommunication services."

(3) Industrial parks / Special Economic Zones: Any undertaking which develops, develops and operates, or maintains and operates an industrial park or develops, or develops and operates, or maintains and operates, a special economic zone.

Conditions:

(i) The undertaking begins to operate an industrial park or special economic zone in accordance with the scheme framed and notified by the Central Government.

(ii) The scheme is notified by the Government for the period beginning on 1-4-1997 and ending on (i) *31-3-2011 for industrial parks* and (ii) 31.3.2006 for SEZs.

Rule 18C lays down the following eligibility criteria for Industrial Parks to claim benefit under section 80-IA (4)(iii) -

(1) The undertaking should begin to develop, develop and operate or maintain and operate an industrial park any time during the period from 1.4.2006 to 31.3.2009.

(2) The undertaking and the Industrial Park should be notified by the Central Government under the Industrial Park Scheme, 2008.

(3) The undertaking should continue to fulfill the conditions envisaged in the Industrial Park Scheme, 2008.

(iii) However, where an undertaking develops an industrial park on or after 1.4.99 or a special economic zone on or after 1.4.01 and transfers the operation and maintenance to another undertaking (transferee undertaking), the deduction to the transferee undertaking shall be available for the remaining period in the ten consecutive assessment years, in such a manner as would have been available to the transferor undertaking, as if the operation and maintenance were not so transferred to the transferee undertaking.

(4) Power undertakings: Any undertaking which

(i) is set up in any part of India for the generation or generation and distribution of power. However, such undertaking must begin to generate power at any time during the period between 1.4.1993 *and 31.3.2011*.

(ii) starts transmission or distribution by laying a network of new transmission or distribution lines at any time during the period from 1.4.1999 *and 31.3.2011.* However, the deduction shall be allowed only in respect of profits derived from the laying of such network of new lines for transmission or distribution.

(iii) undertakes substantial renovation and modernisation of the existing network of transmission or distribution lines at any time during the period beginning on 1.4.2004 and ending on *31.3.2011*.

'Substantial renovation and modernisation' means an increase in the plant and machinery in the network of transmission or distribution lines by at least fifty per cent of the book value of such plant and machinery as on 1st April, 2004.

Telecom and Power undertakings should fulfill the following conditions:

(a) It is not formed by splitting up or reconstruction of a business already in existence. However, this condition shall not apply in the case of an undertaking which is formed as a result of reconstruction, re-establishment or revival of the business of any undertaking which has been discontinued in any previous year due to extensive damage or destruction of any building, machinery, plant or furniture owned by the assessee and used for the purposes of such business. Further, the reason for damage or destruction is due to any natural calamity or other unforeseen circumstances such as the following:

(i) Flood, typhoon, hurricane, cyclone, earthquake or other natural calamity, or

(ii) riot or civil disturbance, or

(iii) accidental fire or explosion, or

(iv) enemy action or action taken in combat,

and such business is re-established or revived within 3 years from the end of such previous year.

(b) The undertaking should not be formed by the transfer of machinery or plant previously used for any purpose.

However, these conditions do not apply in case of transfer, either in whole or in part, of machinery or plant previously used by a State Electricity Board. This is irrespective of whether or not such transfer is in pursuance of the splitting up or reconstruction of such State Electricity Board or reorganisation of the State Electricity Board under Part XIII of the Electricity Act, 2003.

Also, this condition shall not apply to second-hand machinery or plant imported by the assessee if the following conditions are fulfilled:

(i) Such machinery or plant was not used in India prior to the date of installation by the assessee.

(ii) No deduction on account of depreciation was allowed to any person prior to the date of installation by the assessee.

Further, where the total value of any plant or machinery previously used and now transferred to the new business does not exceed 20% of the total value of the machinery or plant used in the new business, such plant or machinery will be considered as new for this purpose.

(5) Undertakings owned by an Indian company and set up for reconstruction or revival of a power generating plant

(i) Clause (v) provides that the benefit under this section is available to an undertaking owned by an Indian company and set up for reconstruction or revival of a power generating plant.

(ii) Such Indian company should be formed before 30.11.2005 with majority equity participation by public sector companies for the purposes of enforcing the security interest of the lenders to the company owning the power generating plant.

(iii) Such Indian company should have been notified before 31.12.2005 by the Central Government for the purposes of this clause.

(iv) Such undertaking should begin to generate or transmit or distribute power before *31.3.2011*.

(ii) Rate of Deduction

(1) The amount of deduction available will be 100% of the profits and gains derived from such business for ten consecutive assessment years commencing at any time during the periods specified in (iii) below.

(2) However, in case of telecom undertakings covered under (2) above, the deduction will be 100% for the first 5 assessment years and thereafter 30% for the further 5 assessment years.

(iii) Period of tax holiday/concession

(1) The assessee has the option to claim deduction for any 10 consecutive assessment years out of 15 years beginning from the year in which the undertaking or the enterprise develops or begins to operate the eligible business.

(2) The assessee may also claim deduction for 10 out of 15 years beginning from the year in which an undertaking undertakes substantial renovation and modernization of the existing transmission or distribution lines.

(3) In case of an infrastructure facility being a public facility like –

(i) a road, including a toll road, bridge or rail system; or

(ii) a highway project including housing or other activities which are an integral part of the highway project; or

(iii) a water supply project, water treatment system, irrigation project, sanitation and sewerage system or solid waste management system,

the assessee can claim deduction for any 10 consecutive assessment years out of 20 years beginning from the year of operation.

(iv) Other provisions

(1) For the purpose of computing deduction under this section, the profits and gains of the eligible business shall be computed as if such eligible business were the only source of income of the assessee during the relevant previous years [Sub-section (5)].

(2) Where housing or other activities are an integral part of a highway project and the profits and gains have been calculated in accordance with the section, the profits shall not be liable to tax if the following conditions have been fulfilled:

(a) The profit has been transferred to a special reserve account; and

(b) the same is actually utilised for the highway project excluding housing and other activities before the expiry of 3 years following the year of transfer to the reserve account;

(c) The amount remaining unutilised shall be chargeable to tax as income of the year in which the transfer to the reserve account took place [Sub-section (6)].

(3) The deduction shall be allowed to the industrial undertaking only if the accounts of the industrial undertaking for the relevant previous year have been audited by a chartered accountant and the assessee furnishes the audit report in the prescribed form, duly signed and verified by such accountant along with his return of income [Sub-section (7)].

(4) Where any goods or services held for the purposes of the eligible business are transferred to any other business carried on by the assessee, or vice versa, and if the consideration for such transfer does not correspond with the market value of the goods or services then the profits and gains of the eligible business shall be computed as if the transfer was made at market value. However, if, in the opinion of the Assessing Officer, such computation presents exceptional difficulties, the Assessing Officer may compute the profits on such reasonable basis as he may deem fit [Sub-section (8)].

For the above purpose, "market value" means the price such goods or services would ordinarily fetch in the open market.

(5) The deductions claimed and allowed under this section shall not exceed the profits and gains of the eligible business. Further, where deduction is claimed and allowed under this section for any assessment year no deduction in respect of such profits will be allowed under any other section under this chapter [Sub-section (9)].

(6) Where it appears to the Assessing Officer that the assessee derives more than ordinary profits from the eligible business due to close connection between the assessee and any other person, or due to any other reason, the Assessing Officer may consider such profits as may be reasonable for the purpose of computing deduction under this section [Sub-section (10)].

(7) The section empowers the Central Government to declare any class of industrial undertaking or enterprise as not being entitled to deduction under this section. The denial of exemption shall be with effect from such date as may be specified in the notification issued in the Official Gazette [Sub-section (11)].

(8) In the case of any amalgamation or demerger, by virtue of which the Indian company carrying on the eligible business is transferred to another Indian company, deduction under this section will be available as follows:

(a) No deduction will be available to the amalgamating company or the demerged company, as the case may be, in the year of amalgamation/demerger.

(b) The provisions of this section will apply to the amalgamated/resulting company as they would have applied to the amalgamating/demerged company if the amalgamation/demerger had not taken place [Sub-section (12)].

However, such transfer of benefit of deduction to the amalgamated/resulting company would not be available in respect of any enterprise or undertaking which is transferred in a scheme of amalgamation or demerger effected on or after 1.4.2007 [Sub-section (12A)].

(9) The deduction under section 80-IA would not be available in respect of any SEZ notified on or after 1.4.2005 in accordance with the Industrial Park Scheme, 2002 and notified schemes for SEZs, referred to in section 80-IA(4)(c)(iii) [Sub-section (13)].

(10) The tax holiday under section 80-IA would not be available in relation to a business referred to in sub-section (4) which is in the nature of a works contract awarded by any person (including the Central or State Government) and executed by the undertaking or enterprise referred to in section 80-IA(1).

11.3.2 Deduction in respect of profits and gains by an undertaking or enterprise engaged in development of SEZ [Section 80-IAB]

(i) Sub-section (1) provides for a deduction of 100% of profits and gains derived by an undertaking or an enterprise from any business of developing a SEZ for 10 consecutive assessment years.

(ii) The deduction is available to an assessee, being a Developer, whose gross total income includes any profits and gains derived by an undertaking or an enterprise from any business of developing a SEZ, notified on or after 1st April, 2005 under the SEZ Act, 2005.

(iii) Developer means -

(a) a person who, or

(b) a State Government which

has been granted a letter of approval by the Central Government under section 3(10) of the SEZ Act, 2005.

A developer includes –

(a) an authority and

(b) a Co-developer.

(iv) Co-developer means -

(a) a person who, or

(b) a State Government which

has been granted a letter of approval by the Central Government under section 3(12) of the SEZ Act, 2005.

(v) The deduction shall be allowed only if the accounts are audited by a Chartered Accountant and the audit report is furnished along with the return of income.

(vi) The assessee has the option of claiming the said deduction for any ten consecutive assessment years out of fifteen years beginning from the year in which a SEZ has been notified by the Central Government.

(vii) In a case where an undertaking, being a Developer, who develops a SEZ on or after 1.4.2005 and transfers the operation and maintenance of such SEZ to another Developer, the deduction under sub-section (1) shall be allowed to such transferee Developer for the remaining period in the ten consecutive assessment years as if the operation and maintenance were not so transferred to the transferee Developer.

(viii) The profits and gains from the eligible business should be computed as if such eligible business were the only source of income of the assessee during the relevant assessment year.

(ix) Where any goods or services held for the purposes of eligible business are transferred to any other business carried on by the assessee or, where any goods held for any other business are transferred to the eligible business and, in either case, if the consideration for such transfer as recorded in the accounts of the eligible business does not correspond to the market value thereof, then the profits eligible for deduction shall be computed by adopting market value for such goods or services. In case of exceptional difficulty in this regard, the profits shall be computed by the Assessing Officer on a reasonable basis. Similarly, where due to the close connection between the assessee and the other person or for any other reason, it appears to the Assessing Officer that the profits of eligible business is increased to more than the ordinary profits, the Assessing Officer shall compute the amount of profits on a reasonable basis for allowing the deduction.

(x) The deduction under this section should not exceed the profits of such eligible business of the undertaking or the enterprise.

(xi) Further, where any amount of profits of an undertaking or enterprise is allowed as deduction under this section, no deduction under any other provision of Chapter VI-A is allowable in respect of such profits.

(xii) The Central Government may notify that the benefit conferred by this section shall not apply to any class of industrial undertaking or enterprise with effect from any specified date.

(xiii) Where any undertaking of an Indian company which is entitled to the deduction under this section is transferred before the expiry of the period of deduction to another Indian company in a scheme of amalgamation or demerger, no deduction shall be admissible to the amalgamating or demerged company for the previous year in which the amalgamation or demerger takes place and the amalgamated or the resulting company shall be entitled to the deduction as if the amalgamation or demerger had not taken place.

11.30 Income Tax

11.3.3 Deductions in respect of profits and gains from certain industrial undertakings other than infrastructure development undertakings, etc. [Section 80-IB]

(i) Applicability

This section will be applicable to assesses, whose gross total income includes any profits and gains derived from any of the following business activities -

(1) An industrial undertaking including a small scale industrial undertaking (SSI)

(2) A ship

(3) A hotel, multiplex theatre or convention centre.

(4) Any company carrying on scientific and industrial research and development

(5) An undertaking which begins commercial production or refining of mineral oil *or commercial production of natural gas in licensed blocks*

(6) An undertaking engaged in construction and development of housing projects approved by a local authority

(7) An industrial undertaking deriving profits from the business of setting up and operating a cold chain facility for agricultural produce.

(8) An undertaking deriving profits from the business of processing, preservation and packaging of fruits or vegetables *or meat and meat products or poultry or marine or dairy products* or from the integrated business of handling, storage and transportation of foodgrains.

(9) An undertaking operating and maintaining a hospital in a rural area.

(ii) Conditions to be fulfilled, amount of deduction and period of deduction

The rate and period of deduction and the conditions required to be satisfied by the different categories of businesses are given below :

(1) Industrial undertakings [Sub-sections (2), (3), (4) and (5)]

Conditions: In order to be eligible to claim deduction under section 80-IB, an industrial undertaking must fulfill the following conditions:

(i) It is not formed by splitting up, or the reconstruction of, an existing business.

(ii) It is not formed by the transfer to a new business of any plant or machinery previously used for any other purpose.

In order to satisfy this condition, the total value of the plant or machinery so transferred should not exceed 20% of the value of the total plant or machinery used in the new business.

For the purpose of this condition, machinery or plant would not be regarded as previously used if it had been used by any person other than the assessee provided the following conditions are satisfied:

(a) such plant or machinery was not used in India at any time prior to the date of its installation by the assessee;

(b) the plant or machinery was imported into India from a foreign country;

(c) no deduction in respect of depreciation of such plant or machinery has been allowed to any person at any time prior to the date of installation by the assessee.

(iii) It manufactures or produces any article or thing (except those specified in the Eleventh Schedule) or operates a cold storage plant, in any part of India. However, in the case of an SSI, restriction regarding goods specified in the Eleventh Schedule shall not apply.

(iv) In case of a manufacturing industrial unit, it should employ 10 or more workers (if manufacture is carried on with the aid of power), or 20 or more workers (if manufacture is carried on without the use of power).

Rate and period of deduction : The rate and period of deduction for different categories of industrial undertakings are given below :

(i) The amount of deduction for an industrial undertaking will be 25% of the profits and gains derived from such industrial undertaking for a period of 10 consecutive assessment years starting with the initial assessment year, i.e. the assessment year relevant to the previous year in which the industrial undertaking begins to manufacture or produce articles or things. In the case of a company, the rate of deduction will be 30%. Again, where the assessee is a co-operative society, the period of 10 consecutive years will become 12 consecutive assessment years.

However, in order to claim the amount of deduction specified here, the assessee must fulfil the following conditions:

(a) It must have begun to manufacture or produce articles or things or operate the plants at any time between 1-4-1991 and 31-3-1995, or such further period as specified by the Central Government in the Official Gazette with respect to such class of industries.

(b) In case of an SSI, the period specified for the above purpose is 1-4-1995 and 31-3-2002.

"Small-scale industrial undertaking" means an industrial undertaking which is, as on the last day of the previous year, regarded as a small-scale industrial undertaking under section 11B of the Industrial (Development and Regulation) Act, 1951.

(ii) In case of the following categories of industrial undertakings, the amount and period of deduction will be 100% of the profits and gains derived from the industrial undertaking for the initial 5 assessment years and thereafter 25% of such profits and gains (in case of a company, the rate is 30%):

(a) an industrial undertaking located in an industrially backward State specified in the Eighth Schedule. In this case, the total period of deduction should not exceed 10

consecutive assessment years provided the industrial undertaking begins manufacture or production of articles or things or operation of cold storage plant between 1-4-1993 and 31-3-2004. Where the industrial undertaking is a co-operative society, the deduction will be available for 12 assessment years (instead of 10), including the initial assessment year [Sub-section (4)]

However, the terminal date for setting up of industrial undertakings in the State of Jammu and Kashmir is 31.3.2012. A negative list has also been provided in Part C of the Thirteenth Schedule to specify the commodities which should not be manufactured or produced by such undertakings. The list includes Cigarettes/cigars of tobacco, manufactured tobacco and substitutes, distilled/brewed alcoholic drinks and aerated branded beverages and their concentrates.

The Eighth Schedule specifies the following to be industrially backward States and Union Territories: (1) Arunachal Pradesh (2) Assam (3) Goa (4) Himachal Pradesh (5) Jammu & Kashmir (6) Manipur (7) Meghalaya (8) Mizoram (9) Nagaland (10) Sikkim (11) Tripura (12) Andaman and Nicobar Islands (13) Dadra and Nagar Haveli (14) Daman & Diu (15) Lakshadweep (16) Pondicherry

In case of notified industries in the North-eastern region of India, the amount of deduction will be 100% of the profits and gains for 10 consecutive assessment years. However, no such deduction shall be allowed to any undertaking or enterprise which is eligible for claiming benefit under section 80-IC.

"North-eastern region" means the region comprising the States of Arunachal Pradesh, Assam, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim and Tripura.

(b) an industrial undertaking located in such industrially backward districts of Category A or B, as the Central Government may, having regard to the prescribed guidelines, specify in the Official Gazette.

In case of Category A industries, the total period of deduction is 10 consecutive assessment years (except in case of a co-operative society where it is 12 years) provided the undertaking begins manufacture or production of articles or things or operation of cold storage plant between 1-10-1994 and 31-3-2004.

In case of Category B industries, the total period of deduction is 8 consecutive assessment years (except in case of a co-operative society where it is 12 years) provided the undertaking begins manufacture or production of articles or things or operation of cold storage plant between 1-10-1994 and 31-3-2004.

(2) Ships [Sub-section (6)]

Conditions: In order to claim deduction under this section, the following conditions must be fulfilled:

(i) It should be owned by an Indian company and should be wholly used for its business purposes.

(ii) It was not owned or used in Indian territorial waters by any person resident in India prior to the date of its acquisition by the Indian company.

(iii) It was brought into use by the Indian company at any time between 1.4.91 and 31.3.95.

Rate and period of deduction : The amount of deduction will be 30% of the profits and gains derived from such a ship for a period of 10 consecutive assessment years including the initial assessment year i.e., the assessment year relevant to the previous year in which the ship is first bought into use.

(3) Hotels [Sub-section (7)]

Conditions: In order to claim deduction under this section, the following conditions must be fulfilled:

(i) The business of the hotel is not formed by splitting up, or the reconstruction of, an existing business or by the transfer to the new business of a building previously used as a hotel or of any plant or machinery previously used for any purpose.

(ii) The business of the hotel is owned and carried on by a company registered in India with a paid up capital of not less than Rs.5,00,000.

(iii) The hotel is approved by the prescribed authority.

Rate and period of deduction: The rate and period of deduction for different categories of hotels are given below.

(i) In case of hotels located in a hilly area or a rural area or a place of pilgrimage or such other place as the Central Government, having regard to the need for development of infrastructure for tourism in any place or such other considerations, may specify in the Official Gazette, the amount of deduction will be 50% of the profits and gains derived from such business.

The deduction will be available for a period of 10 consecutive assessment years beginning with the initial assessment year i.e. the assessment year relevant to the previous year in which the business of the hotel starts functioning.

In order to claim the deduction, the hotel must start functioning at any time between 1-4-1990 and 31-3-1994 or between 1-4-1997 and 31-3-2001, and should be approved by the prescribed authority for the purpose of deduction under this clause.

However, hotels situated within the municipal jurisdiction of Calcutta, Chennai, Mumbai and Delhi which has started functioning between 1-4-1997 and 31-3-2001 would not be eligible for this deduction.

"Hilly area" means any area located at a height of one thousand metres or more above the sea level.

"Place of pilgrimage" means a place where any temple, mosque, gurdwara, church or other place of public worship of renown throughout any State or States is situated.

"Rural area" means any area other than -

(a) an area which is comprised within the jurisdiction of a municipality or a cantonment board which has a population of not less than 10,000 according to the preceding census of which relevant figures have been published before the first day of the previous year; or

(b) an area within such distance not being more than 15 kilometers from the local limits of any municipality or cantonment board referred to in sub-clause (i), as the Central Government may, having regard to the stage of development of such area including the extent of, and scope for, urbanisation of such area and other relevant considerations specify in this behalf by notification in the Official Gazette.

(ii) In case of hotels located in any place other than those specified in (i) above, the amount of deduction will be 30% of the profits and gains derived from such business.

The deduction will be available for a period of 10 consecutive assessment years beginning with the initial assessment year.

In order to claim the deduction, the hotel must start functioning at any time between 1-4-1991 and 31-3-1995 or between 1-4-1997 and 31-3-2001, and should be approved by the prescribed authority for the purpose of deduction under this clause. However, hotels situated within the municipal jurisdiction of Calcutta, Chennai, Mumbai and Delhi which have started functioning between 1-4-1997 and 31-3-2001 would not be eligible for this deduction.

(4) Multiplex theatres located in cities other than Kolkata, Chennai, Delhi or Mumbai [Sub-section (7A)]

Conditions: (i) The multiplex theatre should be constructed at any time between 1.4.2002 and 31.3.2005,

(ii) The business of the multiplex theatre is not formed by the splitting up, or the reconstruction, of a business already in existence or by the transfer of any building or machinery or plant previously used, to the new business.

(iii) The assessee should furnish along with the return of income, an audit report from a chartered accountant in the prescribed form and manner certifying that the deduction has been correctly claimed.

Rate and period of deduction: The amount of deduction shall be 50% of the profits from the business of building, owning and operating the multiplex theatre. The deduction shall be available for 5 consecutive years beginning with the initial assessment year i.e. the

assessment year relevant to the previous year in which a cinema hall being a part of the multiplex theatre, starts operating on a commercial basis for the above purposes, the related terms have been defined as follows:

"Multiplex theatre" means a building of a prescribed area, comprising of two or more cinema theatres and commercial shops of such size and number and having such other facilities and amenities as may be prescribed.

(5) Convention Centre [Sub-section (7B)]

Conditions: (i) The convention centre should be constructed at any time between 1.4.2002 and 31.3.2005.

(ii) The business of the convention centre is not formed by the splitting up, or the reconstruction, of a business already in existence or by the transfer of any building or machinery or plant previously used, to the new business.

(iii) The assessee should furnish along with the return of income, an audit report from a chartered accountant in the prescribed form and manner certifying that the deduction has been correctly claimed.

Rate and period of deduction: The amount of deduction shall be 50% of the profits from the business of building, owning and operating the convention centre. The deduction shall be available for 5 consecutive years beginning with the initial assessment year i.e. the assessment year relevant to the previous year in convention centre starts operating on a commercial basis.

For the above purpose, "convention centre" means a building of a prescribed area comprising of convention halls to be used for the purpose of holding conferences and seminars being of such size and number and having such facilities and amenities as may be prescribed.

(6) Companies carrying on scientific and industrial research and development [Sub-section (8) & (8A)]

(i) The company is registered in India.

(ii) The company has the main object of scientific and industrial research and development.

(iii) The company is approved by the prescribed authority at any time before 1-4-1999.

Rate and period of deduction : Deduction will be calculated at 100% of the profits and gains from such business for 5 assessment years including the initial assessment year.

Sub-section (8A) provides for deduction in case of a company carrying on scientific research and development if such company fulfils the following conditions:

(i) It is registered in India.

(ii) It has the main object of scientific and industrial research and development.

(iii) It is for the time being approved by the prescribed authority at any time after 31.3.2000 but before 1.4.2007.

(iv) It fulfils such other conditions as may be prescribed.

The amount of deduction shall be 100% of the profits and gains of such business.

The deduction will be available for a period of 10 consecutive assessment years starting with the initial assessment year i.e. the assessment year relevant to the previous year in which the company is approved by the prescribed authority.

(7) Undertakings engaged in commercial production or refining of mineral oil or commercial production of natural gas in licensed blocks [Sub-section (9)]

Conditions: In order to claim deduction under the section, the undertaking should be engaged in commercial production or refining of mineral oil *or commercial production of natural gas in licensed blocks.*

The following further conditions should be fulfilled –

(1) In case of an undertaking engaged in commercial production of mineral oil -

(i) Where such operations are carried out in the North Eastern Region, it has begun commercial production before 1-4-1997.

(ii) Where such operations are carried out in any other part of India, it begins commercial production on or after 1-4-1997.

(2) In case of an undertaking engaged in refining of mineral oil, it begins refining of mineral oil on or after 1-10-1998 *but not later than 31.3.2012*.

(3) In case of an undertaking engaged in commercial production of natural gas in licensed blocks –

(1) the blocks are licensed under the VIII Round of bidding for award of exploration contracts ("NELP-VIII") under the New Exploration Licencing Policy announced by the Government of India vide Resolution No.O-19018/22/95-ONG.DO.VL, dated 10th February, 1999; or

(2) the blocks are licensed under the IV Round of bidding for award of exploration contracts for Coal Bed Methane blocks

and begins commercial production of natural gas on or after 1st April, 2009.

***Note –** All blocks licensed under a single contract to be treated as a single "undertaking"*

For the purposes of claiming deduction under sub-section (9), all blocks licensed under a single contract, which has been awarded -

(1) under the New Exploration Licencing Policy announced by the Government of India vide Resolution No.O-19018/22/95-ONG.DO.VL, dated 10.2.1999 or

(2) in pursuance of any law for the time being in force or

(3) by Central or a State Government in any other manner

shall be treated as a single "undertaking".

This definition of "undertaking" will be applicable both in relation to mineral oil and natural gas.

Rate and period of deduction: The deduction will be allowed at 100% of the profits and gains from such business for 7 consecutive assessment years including the initial assessment year i.e. the assessment year relevant to the previous year in which the undertaking commences the commercial production or refining of mineral oil.

(8) Housing projects [Sub-section (10)]

Conditions: In order to be eligible to claim deduction under section 80-IB, an undertaking developing and building housing projects must fulfil the following conditions:

(i) The undertaking has commenced or commences development and construction of the housing project on or after 1.10.1998. The housing project should be completed within 4 years from the end of the financial year in which the project is approved by the local authority. In respect of projects approved by the local authority before 1.4.2004, the construction should be completed on or before 31.3.2008. For this purpose, the date of approval would be the date on which the building plan is first approved by the local authority and the date of completion of the housing project would be the date on which the completion certificate is issued by such authority.

(ii) The projects must be approved before *31.3.2008* by a local authority.

(iii) The project is on a plot of land which is at least one acre.

In order to encourage the reconstruction and redevelopment of slum dwellings, the conditions that the construction should be completed within 4 years and that the minimum plot size should be one acre have been relaxed. The relaxation is in respect of housing projects carried out in accordance with a scheme framed by the Central Government or a State Government for reconstruction or redevelopment of existing buildings in areas declared to be slum areas. Such a scheme should be notified by the Board in this behalf.

(iv) The residential unit has a maximum built-up area of 1000 sq.ft. (if such residential unit is situated in Delhi or Mumbai or within 25 km from the municipal limits of these cities) or 1500 sq.ft. at any other place.

(v) the built-up area of the shops and other commercial establishments included in the housing project should not exceed five percent. of the aggregate built-up area of the

housing project or 2000 sq. ft., whichever is less.

The expression "built-up area" has been defined to mean the inner measurements of the residential unit at the floor level, including the projections and balconies, as increased by the thickness of the walls but not including the common areas shared with other residential units.

(vi) The undertaking which develops and builds the housing project shall not be allowed to allot more than one residential unit in the housing project to the same person, not being an individual. Where the person is an individual, no other residential unit in such housing project should be allotted to any of the following persons:-

(1) the individual himself or spouse or minor children of such individual;

(2) the Hindu undivided family in which such individual is the karta

(3) any person representing such individual, the spouse or minor children of such individual or the Hindu undivided family in which such individual is the karta.

Rate and period of deduction: The deduction will be allowed at 100% of the profits derived from such project in any previous year relevant to any assessment year.

Note – *The main aim of the tax concession under section 80-IB(10) is to provide tax benefit to the person undertaking the investment risk i.e. the actual developer. However, any person undertaking pure contract risk is not entitled to the tax benefit. Accordingly, the benefit under sub-section (10) would not be available to any undertaking which executes the housing project as a works contract awarded by any other person (including the Central or State Government).*

(9) Cold chain facilities for agricultural produce [Sub-section (11)]

Conditions: In order to claim deduction under this section, the assessee must fulfil the following conditions:

(i) The industrial undertaking should be deriving profit from the business of setting up and operating a cold chain facility for agricultural produce.

(ii) The undertaking must begin to operate such facility on or after 1-4-1999 but before 1-4-2004.

For the purposes of this section, "cold chain facility" means a chain of facilities for storage or transportation of agricultural produce under scientifically controlled conditions including refrigeration and other facilities necessary for the preservation of such produce.

Rate and period of deduction: The amount of deduction will be 100% of the profits and gains derived from such industrial undertaking for a period of 5 consecutive assessment years starting with the initial assessment year i.e. the assessment year relevant to the previous year in which the industrial undertaking begins to operate the cold chain facility. Thereafter, the deduction allowable is 25% of such profits and gains (30% in case of a

company) for the next 5 assessment years.

Where the assessee is a co-operative society, the period of 10 consecutive years will become 12 consecutive assessment years.

(10) Undertakings engaged in handling of foodgrains etc. [Sub-section (11A)]

Conditions: In order to claim deduction, the undertaking should fulfill the following conditions:

(i) It should be deriving profits from the business of processing, preservation and packaging of fruits or vegetables or from the integrated business of handling, storage and transportation of foodgrains.

(ii) It should begin to operate such business on or after 1.4.2001.

(iii) The benefit of deduction under sub-section (11A) has now been extended to an undertaking deriving profit from the business of processing, preservation and packaging of meat or meat products or poultry or marine or dairy products, if it begins to operate such business on or after 1.4.2009.

Rate and period of deduction: The amount of deduction shall be 100% of the profits and gains derived from such business for 5 assessment years beginning with the initial assessment year i.e. the assessment year relevant to the previous year in which the undertaking begins such business. Thereafter, the deduction allowable is 25%. In the case of a company, the rate of 25% shall be substituted by 30%. The total period of deduction should not exceed 10 consecutive assessment years.

(11) Undertakings operating and maintaining a hospital in a rural area [Sub-section (11B)]

(i) The profits derived by an undertaking from the business of operating and maintaining a hospital in a rural area is eligible for a deduction of hundred per cent of such profits and gains.

(ii) The deduction is available for a period of five consecutive assessment years beginning from the initial assessment year (i.e. assessment year relevant to the previous year in which the undertaking begins to provide medical services).

(iii) The undertaking would be eligible for the deduction if such hospital -

(a) is constructed during the period beginning on the 1st October, 2004 and ending on 31st March, 2008;

(b) has at least one hundred beds for patients; and

(c) is constructed in accordance with the regulations in force of the local authority.

(iv) Further, for claiming the deduction, the assessee has to file along with the return of income, an audit report in the prescribed form and in the prescribed manner, duly signed and verified by a chartered accountant.

11.40 Income Tax

(12) Undertakings operating and maintaining a hospital located anywhere in India, other than the excluded area [Sub-section (11C)]

(i) Sub-section (11C) provides a five year tax holiday to hospitals set up in other than the excluded areas. Excluded area means the area comprising the urban agglomerations of Greater Mumbai, Delhi, Kolkata, Chennai, Hyderabad, Bangalore and Ahmedabad, the districts of Faridabad, Gurgaon, Ghaziabad, Gautam Budh Nagar and Gandhi Nagar and the city of Secunderabad.

(ii) To be eligible for this benefit, the hospital should be constructed and should start functioning between 1.4.08 to 31.3.2013. Further, it should have at least 100 beds for patients. For claiming this benefit, it is necessary that the audit report signed and verified by a Chartered Accountant certifying that deduction has been correctly claimed should be filed along with the company's return of income.

(iii) The construction of the hospital should be in accordance with the regulations or bye-laws of the local authority. The hospital shall be deemed to have been constructed on the date on which a completion certificate in respect of such construction is issued by the local authority concerned.

(iii) Other Provisions

(1) For the purpose of computing deduction under this section, the profits and gains of the eligible business shall be computed as if such eligible business were the only source of income of the assessee during the relevant previous years.

(2) The accounts of the industrial undertaking for the relevant previous year should be audited by a chartered accountant and the assessee should furnish the audit report in the prescribed form, duly signed and verified by such accountant along with the return of income.

(3) Where any goods held for the purposes of the eligible business are transferred to any other business carried on by the assessee, or vice versa, and if the consideration for such transfer does not correspond with the market value of the goods, then, the profits and gains of the eligible business shall be computed as if the transfer was made at market value. However, if, in the opinion of the Assessing Officer, such computation presents exceptional difficulties, the Assessing Officer may compute the profits on such reasonable basis as he may deem fit.

For the above purpose, "market value" means the price such goods would ordinarily fetch on sale in the open market.

(4) The deduction claimed and allowed under this section shall not exceed the profits and gains of the eligible business. Further, where deduction is claimed and allowed under this section for any assessment year, no deduction in respect of such profits will be allowed under any other section under this Chapter.

(5) Where it appears to the Assessing Officer that the assessee derives more than ordinary profits from the eligible business due to close connection between him and any other person, or due to any other reason, the Assessing Officer may consider such profits as may be reasonable for the purpose of computing deduction under this section.

(6) The section empowers the Central Government to declare any class of industrial undertaking or enterprise as not being entitled to deduction under this section. The denial of exemption shall be with effect from such date as may be specified in the notification issued in the Official Gazette.

(7) In the case of any amalgamation or demerger, by virtue of which the Indian company carrying on the eligible business is transferred to another Indian company, deduction under this section will be available as follows:

(a) No deduction will be available to the amalgamating company or the demerged company, as the case may be, in the year of amalgamation/demerger.

(b) The provisions of this section will apply to the amalgamated/resulting company as they would have applied to the amalgamating/demerged company, if the amalgamation/demerger had not taken place.

11.3.4 Special provisions in respect of certain undertakings or enterprises in certain undertakings or enterprises in certain special category States [Section 80-IC]

(i) This section allows tax holiday to the new undertakings or existing undertakings on their substantial expansion in the states of Himachal Pradesh, Uttaranchal, Sikkim and North-Eastern States.

(ii) For this purpose, substantial expansion means increase in the investment in plant and machinery by at least 50% of the book value of the plant and machinery (before taking depreciation in any year), as on the first day of the previous year in which the substantial expansion is undertaken.

(iii) The tax holiday in the states of Himachal Pradesh and Uttaranchal will be 100% for the first five assessment years and 25% (30% in the case of a company) for the next five assessment years.

(iv) However, tax holiday in the states of Sikkim and North-Eastern States will be 100% for ten assessment years commencing from the initial assessment year.

(v) For the purpose of exemption, two classifications have been made and the Thirteenth Schedule and Fourteenth Schedule have been inserted in the Income-tax Act. The said Schedules specify the list of articles and the States for the purposes of availing deduction under this section.

(vi) The first classification is applicable to undertakings or enterprises which manufacture

or produce any article or thing, not being any article or thing specified in the 13th Schedule (namely, tobacco, aerated beverages, pollution causing paper and paper products etc.) in any export processing zone or integrated infrastructure development centre or industrial growth centre or industrial estate or industrial park or software technology park or industrial areas or theme park in these States as notified by the Board.

(vii) The second classification is applicable to those undertakings or enterprises which manufacture or produce article or thing specified in the 14th Schedule only in these States without any specification of the specified zone, area etc.

(viii) The period during which the undertakings in different States should begin or should have begun to manufacture or produce are given hereunder -

Himachal Pradesh and Uttaranchal	From 7.1.03 and ending before 1.4.2012
Sikkim	From 23.12.02 and ending before 1.4.2007
North-Eastern States	From 24.12.97 and ending before 1.4.2007

(ix) No benefit to these undertakings will be available under any of the sections in Chapter VIA or section 10A or section 10B in relation to the profits and gains of such undertakings.

(x) While computing the total period of 10 years the period for which the benefit under section 80IB or under section 10C has already been availed, if any, shall also be included.

(xi) The other conditions such as that it should not be formed by splitting or reconstruction of a business already in existence, or by transfer to a new business of plant and machinery previously used for any purpose are the same as are applicable for claiming benefit under section 80IA.

11.3.5 Tax holiday in respect of profits and gains from the business of hotel or business of building, owning and operating a convention centre in NCR [Section 80-ID]

(i) Section 80-ID provides for a deduction of 100% of profits and gains derived by an undertaking from the eligible business i.e. business of hotel or business of building, owning and operating a convention centre in a specified area, for a period of 5 consecutive assessment years beginning from the year in which such hotel starts functioning or convention centre starts operating on a commercial basis.

(ii) However, such hotel or convention centre should be constructed at any time during the period from 1.4.2007 to 31.3.2010.

(iii) Specified area means the National Capital Territory of Delhi and the districts of Faridabad, Gurgaon, Gautam Budh Nagar and Ghaziabad. This is to boost the construction activity in NCR in view of the upcoming Common Wealth Games in 2010.

(iv) The benefit of this five year tax holiday has now been extended to new two, three or

four star hotels located in specified districts having a World Heritage Site. The specified districts are Agra, Jalgaon, Aurangabad, Kancheepuram, Puri, Bharatpur, Chhatarpur, Thanjavur, Bellary, South 24 Parganas, Chamoli, Raisen, Gaya, Bhopal, Panchmahal, Kamrup, Goalpara, Nagaon, North Goa, South Goa, Darjeeling and Nilgiri. For availing this benefit, the hotel should be constructed and should start functioning between 1.4.08 to 31.3.2013.

(v) "Convention centre" means a building of a prescribed area comprising of convention halls to be used for the purpose of holding conferences and seminars, being of such size and number and having such other facilities and amenities, as may be prescribed.

Rule 18DE prescribes the following conditions to be fulfilled by a convention centre in order to be eligible for deduction under section 80-ID:

(a) the convention centre shall have a minimum covered plinth area of 25,000 sq. mts;

(b) it shall have minimum of 3,000 seating capacity;

(c) there shall be minimum of 10 convention halls;

(d) the convention centre shall have convention halls, whether called conference halls or seminar halls or auditorium for holding seminars and conferences;

(e) each convention hall of the convention centre shall be equipped with modern public address system, slide and power-point projection system and LCD projector or video screening facility;

(f) the convention centre shall have a documentation centre with computers and printers, telephone with STD or ISD facilities, e-mail, photocopy and scanning facility along with trained operators to provide these facilities;

(g) the convention centre shall be completely centrally air-conditioned;

(h) the convention centre shall have adequate parking facility and other public convenience as per local building regulations and should also fulfill all local building regulations in respect of fire and safety.

In addition to the above facilities, the convention centers may have the following:

(a) an amphitheatre and landscaped open spaces for outdoor conference or seminar related activities;

(b) a kitchen, dining facility, cafeteria or restaurant only to support events in the convention centre.

(vi) "Hotel" means a hotel of two-star, three-star or four-star category as classified by the Central Government;

(vii) Such business should not be formed by the splitting up, or the reconstruction, of a business already in existence. It should not be formed by the transfer to a new business of a building previously used as a hotel or convention center. Further, it should not be formed by the transfer to a new business of machinery or plant previously used for any purpose exceeding 20% of the total value of machinery and plant used in the business.

(viii) For this purpose, any machinery or plant which was used outside India by any person other than the assessee shall not be regarded as machinery or plant previously used for any purpose if the following conditions are fulfilled:

(a) such machinery or plant was not at any time used in India;

(b) such machinery or plant is imported into India from any country outside India; and

(c) no deduction on account of depreciation has been allowed in respect of such machinery or plant to any person earlier.

(ix) The profits and gains from the eligible business should be computed as if such eligible business were the only source of income of the assessee during the relevant assessment year.

(x) The deduction under this section should not exceed the profits of such eligible business of the undertaking.

(xi) The deduction shall be allowed only if the accounts are audited by a Chartered Accountant, who is also required to certify that the deduction has been correctly claimed. Further, the audit report should be furnished along with the return of income.

(xii) Further, where any amount of profits of an undertaking or enterprise is allowed as deduction under this section, no deduction under any other provision of Chapter VI-A or section 10AA is allowable in respect of such profits.

(xiii) Where any goods or services held for the purposes of eligible business are transferred to any other business carried on by the assessee or, where any goods held for any other business are transferred to the eligible business and, in either case, if the consideration for such transfer as recorded in the accounts of the eligible business does not correspond to the market value thereof, then the profits eligible for deduction shall be computed by adopting market value for such goods or services. In case of exceptional difficulty in this regard, the profits shall be computed by the Assessing Officer on a reasonable basis.

(xiv) Similarly, where due to the close connection between the assessee and the other person or for any other reason, it appears to the Assessing Officer that the profits of eligible business is increased to more than the ordinary profits, the Assessing Officer shall compute the amount of profits on a reasonable basis for allowing the deduction.

(xv) The Central Government may notify that the benefit conferred by this section shall not apply to any class of undertaking with effect from any specified date.

11.3.6 Tax holiday in respect of profits and gains from eligible business of certain undertakings in North-Eastern States [Section 80-IE]

(i) This section provides for an incentive to an undertaking which has during the period between 1st April, 2007 and 1st April, 2017, begun or begins, in any of the North-Eastern States (i.e., the States of Arunachal Pradesh, Assam, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim and Tripura) -

(1) to manufacture or produce any eligible article or thing;

(2) to undertake substantial expansion to manufacture or produce any eligible article or thing;

(3) to carry on any eligible business.

(ii) Eligible article or thing means the article or thing other than the following -

(a) goods falling under Chapter 24 of the First Schedule to the Central Excise Tariff Act, 1985 which pertains to tobacco and manufactured tobacco substitutes;

(b) pan masala as covered under Chapter 21 of the First Schedule to the Central Excise Tariff Act, 1985;

(c) plastic carry bags of less than 20 microns; and

(d) goods falling under Chapter 27 of the First Schedule to the Central Excise Tariff Act, 1985 produced by petroleum oil or gas refineries.

(iii) Substantial expansion means increase in the investment in the plant and machinery by at least 25% of the book value of plant and machinery (before taking depreciation in any year), as on the first day of the previous year in which the substantial expansion is undertaken.

(iv) Eligible business means the business of -

(a) hotel (not below two star category);

(b) adventure and leisure sports including ropeways;

(c) providing medical and health services in the nature of nursing home with a minimum capacity of 25 beds;

(d) running an old-age home;

(e) operating vocational training institute for hotel management, catering and food craft, entrepreneurship development, nursing and para-medical, civil aviation related training, fashion designing and industrial training;

(f) running information technology related training centre;

(g) manufacturing of information technology hardware; and

(h) Bio-technology.

(v) Where the gross total income of an assessee includes any profits and gains derived by such an undertaking, a deduction of 100% of the profits and gains derived from such business for 10 consecutive assessment years commencing with the initial assessment year shall be allowed in computing the total income of the assessee. Initial assessment year means the assessment year relevant to the previous year in which the undertaking begins to manufacture or produce articles or things, or completes substantial expansion.

(vi) However, the following conditions have to be fulfilled by the undertaking for claiming benefit of deduction under this section -

(1) It should not be formed by splitting up, or the reconstruction, of a business already in existence (except in circumstances provided in section 33B)

(2) It should not be formed by the transfer to a new business of machinery or plant previously used for any purpose exceeding 20% of the total value of machinery and plant used in the business.

(vii) For this purpose, any machinery or plant which was used outside India by any person other than the assessee shall not be regarded as machinery or plant previously used for any purpose if the following conditions are fulfilled:

(a) such machinery or plant was not at any time used in India;

(b) such machinery or plant is imported into India from any country outside India; and

(c) no deduction on account of depreciation has been allowed in respect of such machinery or plant to any person earlier.

(viii) Where deduction has been allowed under this section in computing the total income of the assessee, no deduction shall be allowed under any other section contained in Chapter VIA or in section 10A or section 10AA or section 10B or section 10BA, in relation to the profits and gains of the undertaking.

(ix) Further, no deduction shall be allowed to any undertaking under this section, where the total period of deduction inclusive of the period of deduction under this section, or under section 80-IC or under the second proviso to sub-section (4) of section 80-IB or under section 10C, as the case may be, exceeds 10 assessment years.

(x) The profits and gains from the eligible business should be computed as if such eligible business were the only source of income of the assessee during the relevant assessment year.

(xi) The deduction under this section should not exceed the profits of such eligible business of the undertaking.

(xii) The deduction shall be allowed only if the accounts are audited by a Chartered Accountant, who is also required to certify that the deduction has been correctly claimed. Further, the audit report should be furnished along with the return of income.

(xiii) Where any goods or services held for the purposes of eligible business are transferred to any other business carried on by the assessee or, where any goods held for any other business are transferred to the eligible business and, in either case, if the consideration for such transfer as recorded in the accounts of the eligible business does not correspond to the market value thereof, then the profits eligible for deduction shall be computed by adopting market value for such goods or services. In case of exceptional difficulty in this regard, the profits shall be computed by the Assessing Officer on a reasonable basis.

(xiv) Similarly, where due to the close connection between the assessee and the other person or for any other reason, it appears to the Assessing Officer that the profits of eligible business is increased to more than the ordinary profits, the Assessing Officer shall compute the amount of profits on a reasonable basis for allowing the deduction.

(xv) The Central Government may notify that the benefit conferred by this section shall not apply to any class of undertaking with effect from any specified date.

(xvi) Where any undertaking of an Indian company which is entitled to the deduction under this section is transferred before the expiry of the period of deduction to another Indian company in a scheme of amalgamation or demerger, no deduction shall be admissible to the amalgamating or demerged company for the previous year in which the amalgamation or demerger takes place and the amalgamated or the resulting company shall be entitled to the deduction as if the amalgamation or demerger had not taken place.

11.3.7 Deduction in respect of profits and gains from business of collecting and processing of bio-degradable waste [Section 80JJA]

(i) This section provides for deduction in respect of profits and gains from the business of collecting and processing bio-degradable waste.

(ii) The deduction is allowable where the gross total income of an assessee includes any profits and gains derived from any of the following businesses -

(1) collecting and processing or treating of bio-degradable waste for generating power, or

(2) producing bio-fertilizers, bio-pesticides or other biological agents, or

(3) producing bio-gas, or

(4) making pellets or briquettes for fuel or organic manure.

(iii) The deduction allowable under this section is an amount equal to the whole of such profits and gains for a period of five consecutive assessment years beginning with the assessment year relevant to the previous year in which the business commences.

11.3.8 Deduction in respect of employment of new workmen [Section 80JJAA]

(i) In order to encourage the employers to further generate more employment opportunities, section 80JJAA provides an incentive in the form of a special deduction against business profits of a company.

(ii) The deduction shall amount to 30% of additional wages paid to the new regular workmen employed by the assessee in the previous year. The deduction shall be available for three assessment years including the assessment year relevant to the previous year in which the employment is provided.

(iii) The following conditions have to be fulfilled in order to be eligible for the deduction provided in the section:

(1) The assessee should be an Indian company.

(2) Its gross total income should include profits and gains derived from an industrial undertaking.

(3) The industrial undertaking should be engaged in the manufacture or production of any article or thing.

(4) The industrial undertaking should not have been formed by splitting up of an existing undertaking.

(5) The industrial undertaking should not have been formed by amalgamation with another industrial undertaking.

(6) The assessee should furnish along with the return of income a report of a chartered accountant in Form No. 10DA giving the prescribed particulars.

(7) In case of a new industrial undertaking, in the first previous year, it employs more than 100 regular workmen.

(8) In the case of an existing industrial undertaking, the number of regular workers employed during the relevant previous year is equal to at least 110% of the regular workmen employed in such undertaking as on the last day of the preceding year.

(iv) Meaning of "Workman"

As explained above, the industrial undertaking should employ more than 100 workmen. 'Workman' shall have the meaning assigned to it in section 2(s) of the Industrial Disputes Act, 1947 i.e., any person (including an apprentice) employed in any industry to do any

manual, unskilled, skilled, technical, operational, clerical or supervisory work for hire or reward, whether the terms of employment be express or implied, and for the purposes of any proceedings under this Act in relation to an industrial dispute, includes any such person who has been dismissed, discharged or retrenched in connection with, or as a consequence of, that dispute, or whose dismissal, discharge or retrenchment has led to that dispute, but does not include any such person—

(1) who is subject of the Air Force Act, 1950, or the Army Act, 1950, or the Navy Act, 1957; or

(2) who is employed in the police service or as an officer or other employee of a prison; or

(3) who is employed mainly in a managerial or administrative capacity; or

(4) who, being employed in a supervisory capacity, draws wages exceeding one thousand six hundred rupees per menses or exercises, either by the nature of the duties attached to the office or by reason of the powers vested in him, functions mainly of a managerial nature.

(v) Meaning of "Regular Workmen"- he section defines regular workmen as not including:

(1) a casual workman; or

(2) a workman employed through contract labour; or

(3) any other workman employed for a period of less than 300 days during the previous year.

11.3.9 Deduction in respect of certain income of Offshore Banking Units and International Financial Services Centre [Section 80LA]

(i) This section is applicable to the following assessees -

(a) a scheduled bank having an Offshore Banking Unit in a SEZ; or

(b) any bank, incorporated by or under the laws of a country outside India, and having an Offshore Banking Unit in a SEZ; or

(c) a Unit of an International Financial Services Centre (IFSC).

(ii) The deduction will be allowed on account of the following income included in the gross total income of such assessees -

(a) income from an Offshore Banking Unit in a SEZ; or

(b) income from the business referred to in section 6(1) of the Banking Regulation Act, 1949, with -

(1) an undertaking located in a SEZ or

(2) any other undertaking which develops, develops and operates or develops, operates and maintains a SEZ; or

(c) income from any Unit of the IFSC from its business for which it has been approved for setting up in such a Centre in a SEZ.

(iii) The deduction allowable from such income is -

(a) 100% of such income for 5 consecutive assessment years beginning with the assessment year relevant to the previous year in which –

(1) the permission under section 23(1)(a) of the Banking Regulation Act, 1949 was obtained; or

(2) the permission or registration under the SEBI Act, 1992 was obtained; or

(3) the permission or registration under any other relevant law was obtained.

(b) Thereafter, 50% of such income for the next 5 consecutive assessment years.

(iv) The following conditions have to be fulfilled for claiming deduction under this section-

(a) The report of a Chartered Accountant in Form no.10CCF certifying that the deduction has been correctly claimed in accordance with the provisions of this section, should be submitted along with the return of income.

(b) A copy of the permission obtained under section 23(1)(a) of the Banking Regulation Act, 1949 should also be furnished along with the return of income.

11.3.10 Deduction in respect of income of co-operative societies [Section 80P]

(i) Under this section, certain specified income of a co-operative society would be allowed as a deduction, provided such income is included in the gross total income of the society.

(ii) The following items of income would be fully allowed as deduction -

(1) income from the business of banking or providing credit facilities to its members; or

(2) income from a cottage industry; or

(3) income from the marketing of the agricultural produce grown by its members; or

(4) income derived from the purchase of agricultural implements, seeds, livestock or other articles intended for agriculture or for the purpose of supplying them to its members; or

(5) income from processing without the aid of power, of the agricultural produce of its members; or

(6) the business income of labour co-operative societies and societies engaged in fishing and other allied pursuits, such as catching, curing, processing, preserving,

storing and marketing of fish or the purchase of materials and equipment in connection therewith for the purpose of supplying them to their members. However, the exemption in respect of this type of income will be available only in the case of those co-operative societies which, under their rules and by-laws, restrict the voting rights to members who constitute the labour force or who actually carry on the fishing or other allied activities, the co-operative credit societies which provide financial assistance to the society and the State Government.

(iii) This section also provides that in case of a co-operative society being a primary society engaged in supplying milk, oilseeds, fruits or vegetables raised by its members to a federal milk co-operative society or the Government or a local authority or a Government company or a corporation established by or under a Central, State or Provincial Act (being a company or corporation engaged in supplying milk, oilseeds, fruits or vegetables, as the case may be, to the public), the whole of the amount of profits and gains of such business would be exempt from tax by way of deduction from the gross total income of the co-operative society.

(iv) Further, a co-operative society which is engaged in activities other than or in addition to those mentioned above, is not liable to pay any income tax on the first Rs.50,000 of its business income arising from other activities. The limit is Rs.1,00,000 in the case of consumer co-operative societies. Thus, a co-operative society which is engaged in any business activity besides any of the business activities mentioned in (1) to (6) of (ii) above would not be liable to pay any income tax on the whole of its income derived from any of the activities specified and also on the first Rs.1,00,000 or Rs.50,000, as the case may be, of its business income from activities other than those aforesaid.

(v) Any income arising to a co-operative society by way of any interest and dividends derived from its investments with any other co-operative society is deductible in full under this section.

(vi) Any income arising to a co-operative society by way of 'Interest on securities' or 'Income from house property' (chargeable under section 22) is fully deductible under this section where the gross total income of the co-operative society does not exceed Rs.20,000 and it is not a housing society or an urban consumer's society or a society carrying on transport business or a society engaged in the performance of any manufacturing operations with the aid of power. Thus, a majority of small co-operative societies would not have to pay any income-tax.

(vii) The income derived by a co-operative society from the letting out of godowns or warehouses for storage, processing or facilitating the marketing of commodities is fully allowable as deduction.

(viii) Further, where the co-operative society is also entitled to the deduction available under section 80-IA, the deduction under this section shall be allowed with

reference to the gross total income as reduced by the deduction allowable under section 80-IA.

(ix) The benefit under section 80P has been withdrawn in respect of all co-operative banks, other than primary agricultural credit societies (i.e. as defined in Part V of the Banking Regulation Act, 1949) and primary co-operative agricultural and rural development banks (i.e. societies having its area of operation confined to a taluk and the principal object of which is to provide for long-term credit for agricultural and rural development activities). This is for the purpose of treating co-operative banks at par with other commercial banks, which do not enjoy similar tax benefits. The scope of the definition of 'income' as given in section 2(24) has accordingly been widened to include within its ambit, the profits and gains of any business of banking (including providing credit facilities) carried on by a co-operative society with its members.

11.3.11 Deduction in respect of royalty income, etc., of authors of certain books other than text books [Section 80QQB]

(i) Under section 80QQB, deduction of up to a maximum Rs. 3,00,000 is allowed to an individual resident in India in respect of income derived as author i.e the deduction shall be the income derived as author or Rs.3,00,000, whichever is less.

(ii) This income may be received either by way of a lumpsum consideration for the assignment or grant of any of his interests in the copyright of any book.

(iii) Such book should be a work of literary, artistic or scientific nature, or of royalties or copyright fees (whether receivable in lump sum or otherwise) in respect of such book.

(iv) However, this deduction shall not be available in respect of royalty income from textbook for schools, guides, commentaries, newspapers, journals, pamphlets and other publications of similar nature.

(v) Where an assessee claims deduction under this section, no deduction in respect of the same income may be claimed under any other provision of the Income-tax Act, 1961.

(vi) For the purpose of calculating the deduction under this section, the amount of eligible income (before allowing expenses attributable to such income) shall not exceed 15% of the value of the books sold during the previous year. However, this condition is not applicable where the royalty or copyright fees is receivable in lump sum in lieu of all rights of the author in the book.

(vii) For claiming the deduction, the assessee shall have to furnish a certificate in the prescribed manner in the prescribed format, duly verified by the person responsible for making such payment, setting forth such particulars as may be prescribed.

(viii) Where the assessee earns any income from any source outside India, he should

bring such income into India in convertible foreign exchange within a period of six months from the end of the previous year in which such income is earned or within such further period as the competent authority may allow in this behalf for the purpose of claiming deduction under this section.

(ix) The competent authority shall mean the Reserve Bank of India or such other authority as is authorised under any law for the time being in force for regulating payments and dealings in foreign exchange.

11.3.12 Deduction in respect of royalty on patents [Section 80RRB]

(i) This section allows deduction to a resident individual in respect of income by way of royalty of a patent registered on or after 1.4.03 up to an amount of Rs.3 lakhs.

(ii) This deduction shall be available only to a resident individual who is registered as the true and first inventor in respect of an invention under the Patents Act, 1970, including the co-owner of the patent.

(iii) This exemption shall be restricted to the royalty income including consideration for transfer of rights in the patent or for providing information for working or use thereof in India.

(iv) The exemption shall not be available on any consideration for sale of product manufactured with the use of the patented process or patented article for commercial use.

(v) In respect of any such income which is earned from sources outside India, the deduction shall be restricted to such sum as is brought to India in convertible foreign exchange within a period of 6 months or extended period as is allowed by the competent authority (Reserve Bank of India). For claiming this deduction the assessee shall be required to furnish a certificate in the prescribed form signed by the prescribed authority, alongwith the return of income.

(vi) No deduction in respect of such income will be allowed under any other provision of the Income-tax Act.

(vii) Where the patent is subsequently revoked or the name of the assessee was excluded from the patents register as patentee in respect of that patent, the deduction allowed during the period shall be deemed to have been wrongly allowed and the assessment shall be rectified under the provisions of section 155.

(viii) The period of 4 years for rectification shall be reckoned from the end of the previous year in which the order of the revocation of the patent is passed.

11.4 OTHER DEDUCTIONS

Deduction in the case of a person with disability [Section 80U]

(i) Section 80U harmonizes the criteria for defining disability as existing under the Income-tax Rules with the criteria prescribed under the Persons with Disability (Equal Opportunities, Protection of Rights and Full Participation) Act, 1995.

(ii) This section is applicable to a resident individual, who, at any time during the previous year, is certified by the medical authority to be a person with disability. A deduction of Rs.50,000 in respect of a person with disability and *Rs.1,00,000* in respect of a person with severe disability (having disability over 80%) is allowable under this section.

(iii) The benefit of deduction under this section has also been extended to persons suffering from autism, cerebral palsy and multiple disabilities.

(iv) The assessee claiming a deduction under this section shall furnish a copy of the certificate issued by the medical authority in the form and manner, as may be prescribed, along with the return of income under section 139, in respect of the assessment year for which the deduction is claimed.

(v) Where the condition of disability requires reassessment, a fresh certificate from the medical authority shall have to be obtained after the expiry of the period mentioned on the original certificate in order to continue to claim the deduction.

Self-examination questions

1. Write short notes on -
   (i) Deduction in respect of royalty income on patents
   (ii) Deduction in respect of royalty income of authors of certain books.
2. What is the deduction available from the gross total income of a company in respect of any contribution given to a political party?
3. Who are the assessees eligible to claim deduction under section 80LA? What is the quantum of deduction available under this section? What are the conditions to be fulfilled for claiming such deduction?
4. Discuss the provisions of section 80-IAB relating to deduction in respect of profits and gains derived by an undertaking or enterprise engaged in the development of a special economic zone.
5. What are the special provisions in respect of certain undertakings or enterprises in certain special category states as laid down under section 80-IC of the Act.
6. Can income from cold storage be exempt under section 80P(2)(e), by considering the cold storage as a warehouse or godown where goods are stored?

7. Discuss whether the following qualify as an "infrastructural facility" for the purpose of deduction under section 80-IA -

   (i) Structures at the ports for storage.

   (ii) Effluent treatment and conveyance system.

8. (a) Super Cartons (P) Ltd. was engaged in the manufacture of printed, laminated and waxed cartons. As part of the process of making cartons, the printed sheets were brought to the factory of the company and laminated to make the surface of the sheets smooth and attractive. Then, the laminated sheets were punched and the punched paper was pasted with glue to convert into a carton. The company claimed deduction under section 80-IB. The Assessing Officer, however, disallowed the deduction opining that such operations do not constitute 'manufacture' and the assessee was not engaged in any manufacturing operations in order to be eligible to claim deduction under section 80-IB. Discuss whether the opinion of the Assessing Officer is correct.

   (b) Herbal Tea Ltd. set up a small-scale industrial unit in a backward industrial area. It purchased tea leaves powder/granules and dispatched the same to the blend master, who, after going through his own process, suggested the mixing ratio and process of mixing for making the perfect blend of tea. The assessee-company, thus, carried on the activity of blending of different types of leaves obtained from different gardens in a definite ratio resulting in production of a commodity having its own identity. The assessee contended that though such process may not amount to manufacture, it amounted to production and therefore, being an industrial undertaking set up in a backward industrial area and fulfilling all other conditions, it was entitled to avail the benefit of deduction under section 80-IB. The Assessing Officer, however, disallowed the claim of the assessee holding that such process did not amount to manufacture or production of article or thing for the purpose of claiming deduction under section 80-IB. Discuss whether the contention of the Assessing Officer is correct.

9. An industrial undertaking received 'duty drawback' for export of certain articles or things manufactured by it and claimed the same as 'profits and gains derived from an industrial undertaking' for purpose of deduction under section 80-IB. Is the treatment of 'duty drawback' as profits and gains 'derived from' an industrial undertaking for the purpose of availing deduction under section 80-IB correct in law?

10. Azadi co-operative society claimed deduction under section 80P(2)(d) on the gross amount of interest received during the relevant assessment years. The Income-tax Officer found that the payment of interest on loan taken by the society exceeded the receipts and observed that therefore, no separate deduction under section 80P(2)(d) could be given. Should deduction under section 80P(2)(d) be allowed on gross income or net income? Give your answer with reference to a recent case law.

11. A co-operative society engaged in the business of banking seeks your opinion in the matter of eligibility of deduction under section 80P on the following items of income

earned by it during the year ending 31.3.2010:

(i) Interest on investment in Government securities made out of statutory reserves

(ii) Hire charges of safe deposit lockers.

Answers

6. This question was answered by the Allahabad High Court in *CIT v. District Co-ooperative Federation (2005) 144 Taxman 333 / (2004) 271 ITR 0022*. The High Court observed that the the terms 'godowns' and 'warehouses' are synonymous and interchangeable. The common parlance meaning which can be attributed to godowns or warehouses is that they must be used for the purpose of storage of goods, even for a temporary period.

The High Court further observed that in a cold storage, vegetables, fruits and several other articles are stored. This can be established from the dictionary meaning of the term "cold storage" as well as from the following decisions -

1. Calcutta High Court in *CIT v. Radha Nagar Cold Storage (P.) Ltd. (1980) 4 Taxman 351.*
2. Apex Court in *Delhi Cold Storage (P.) Ltd. v. CIT (1991) 59 Taxman 144*

Thus, by giving a liberal interpretation to the provisions of section 80P(2)(e), cold storage can be treated as a warehouse or godown where fixed temperature is maintained. Therefore, cold storage can be said to be a warehouse or godown where goods are stored, and hence, income from cold storage would be exempt.

7. (i) **Structures at the ports for storage -** Circular no. 10/2005, dated 16.12.2005 clarifies that for and from A.Y. 2002-03 onwards, structures at the ports for storage, loading and unloading etc. will be included in the definition of port (which is an infrastructural facility) for the purpose of section 80-IA, if the concerned port authority has issued a certificate that the said structures form part of the port.

(ii) **Effluent treatment and conveyance system** – Under the treatment of effluents and its conveyance system, the effluents emanating from chemical industries are to be conveyed inside the sea through onshore pipeline and before discharging effluent through pipeline, entire load of effluent is to be treated to marine standards. Therefore, it is a part of water treatment system and would accordingly, qualify as an infrastructure facility for the purposes of tax benefit under section 80-IA. This clarification is given in Circular No.1/2006 dated 12.1.2006.

8. (a) This issue came up before the Bombay High Court in *CIT v. Supreme Graphics Creations (P.) Ltd. (2005) 148 Taxman 67*. It was held that the characteristics of the finished goods were totally changed after laminating, corrugating, printing, punching and pasting. Therefore, the assessee was carrying out a manufacturing process for making the laminated cartons.

Therefore, in this case, the opinion of the Assessing Officer is not correct. Super Cartons (P.) Ltd. is carrying out a manufacturing process and is, therefore, eligible

for claiming deduction under section 80-IB.

(b) The High Court of Rajasthan in *D.D. Shah & Bros v. Union of India (2005) 148 Taxman 1 (Raj.)* observed that blending of different qualities of tea possessing different chemical and physical composition so as to produce the specific blend of tea does not involve an act of manufacture. The assessee is not a grower of tea and so he cannot be called the producer of tea. Nor is he engaged in manufacture of potable tea from green leaves. Therefore, the assessee is only a trader in tea and not a producer or manufacturer. The High Court held that the expression 'manufactures or produces any article or thing' under section 80-IB(2)(iii) has been used in generic sense. It does not include any processing of goods, which does not bring out a new or commercially distinct commodity. Blending of different teas by a dealer amounts to processing of tea but falls short of a manufacturing process. Therefore, it does not amount to manufacturing or producing any article or thing within the meaning of section 80-IB.

Therefore, the contention of the Assessing Officer in this case is correct.

9. A similar issue came up before the Delhi High Court in *CIT v. Ritesh Industries Ltd. (2005) 142 Taxman 551*. The High Court observed that the assessee pays duty on the raw materials utilized as inputs and adds his profit component on the total component of costs to arrive at the sale price. It is this profit which is included in the expression 'profits and gains derived from an industrial undertaking'. Merely because under the scheme to encourage exports the duty is refunded subsequently by way of 'duty drawback', it cannot be regarded as the profit or gain 'derived from' the industrial undertaking. It may constitute profits or gains of the business by virtue of section 28, but, it cannot be construed as profits or gains 'derived' from the industrial undertaking since its immediate and proximate source is not the industrial undertaking but the scheme of duty drawback. Irrespective of whether duty drawback is allowed, the profit 'derived from' the industrial undertaking remains to be the profit. On account of the duty drawback, business profit may be increased, but so far as the profits and gains 'derived from' an industrial undertaking is concerned, it will not increase. It will remain the same.

Therefore, in view of the above case, duty drawback cannot be treated as profit 'derived from' the industrial undertaking for the purpose of availing deduction under section 80-IB.

10. This issue came up before the Allahabad High Court in *CIT vs. Dugdh Utpadak Sahkari Sangh Ltd. (2005) 142 Taxman 611*. The High Court observed that even though section 80P(2)(d) provides deduction of the whole of interest income, it is subject to the provisions of section 80AB. Section 80AB provides that the deduction to be made or allowed under any section in Chapter VI-A under the heading "C. – Deductions in respect of certain incomes" shall be allowed only to the extent to which such income is included in the gross total income of the assessee. Therefore, section 80P(2)(d), being part of Chapter VI-A, is subject to section 80AB. Since it is the net interest income which will be included in the gross total income for the purpose of Chapter VI-A deduction, hence, deduction under section 80P(2)(d) has to be allowed only on the net interest income.

11.58 Income Tax

11. (i) Interest earned on investment in Government securities made out of statutory reserves by a co-operative society engaged in banking business is eligible for deduction under section 80P as per the decision of the Supreme Court in *CIT v. Karnataka State Co-operative Apex Bank (2001) 251 ITR 194.* In this case, it was held that the placement of such funds being imperative for the purpose of carrying on banking business, the income therefrom would be income from the assessee's business and there is nothing in section 80P which restricts the exemption to only income derived from working or circulating capital.

(ii) Provision of safe deposit lockers is part of the ordinary banking business. Income from hiring of such lockers is income from banking business and, therefore, eligible for deduction under section 80P. Therefore, the society is entitled to deduction under section 80P in respect of hire charges of safe deposit lockers.

12

INTER-RELATIONSHIP BETWEEN ACCOUNTING AND TAXATION

Are accounting principles and accounting standards recognized under taxation laws? Apparently, this question seems to be very simple. However, when you delve into the depth of the question, you may find that there are conflicting answers – Yes and No. The answer may be yes or no depending on the specific issue in taxation in respect of which the question is raised. In this chapter, we have tried to make an effort to analyse the different facets of this question and find an appropriate answer.

This chapter gives a macro view of the inter-relationship between accounting and taxation. It spells out the extent of recognition of the accounting principles by the judicial forums in settling tax disputes, the extent of convergence and divergence between Accounting Standards and the income-tax law, the treatment of income-tax expense under Accounting Standards, the relevance of method of accounting under income-tax law, the differences in the method of accounting of tax, duty etc. in valuation of stock as per Accounting Standard and the income-tax law, the requirement of compulsory maintenance of prescribed books of account under the income-tax law and the relevance of profit and loss account prepared under the Companies Act for levy of Minimum Alternate Tax (MAT). First of all, let us understand the extent of recognition of the accounting principles by the judicial forums while settling tax disputes.

12.1 RECOGNITION OF ACCOUNTING PRINCIPLES BY JUDICIAL FORUMS WHILE SETTLING TAX DISPUTES

Various judicial authorities in the country, including the Supreme Court of India, have recognized the accounting principles and accounting standards laid down by the ICAI while deciding tax disputes. There have also been instances when Courts have purposefully synchronized the Statements/Guidance Notes/Accounting Standards issued by the Institute while deciding about certain issues from the taxation point of view. However, there have also been occasions when appellate and judicial forums have not followed the accounting principles and Accounting Standards in the context of determining

certain issues under the tax laws. This is for the reason that the courts, having recognized the authenticity of accounting principles and Accounting Standards, have felt that in the matter of computation of income, effect should be given to the specific provisions of the tax laws.

In *Challapalli Sugars Ltd. v CIT 98 ITR 167*, the Supreme Court, while deciding the question of expenditure during construction period, held that interest paid on monies borrowed during construction period should be capitalized. While laying down this principle, the Supreme Court observed that it would be necessary to ascertain the connotation of the expression 'actual cost' in accordance with the normal rules of accounting. Accordingly, the Apex court held that the actual cost will include the interest paid on monies borrowed during the construction period.

In *Tuticorin Alkali Chemicals and Fertilizers Ltd. v. CIT 227 ITR 172*, the Supreme Court referred to the *Challapalli Sugars Ltd's* case and observed that the ICAI is a recognized authority on accounting principles and its view has to be respected. However, while dealing with the question of taxability of interest income from investment of borrowed funds prior to commencement of business, the Court did not follow the research publication and Accounting Standard of the Institute and held that the income was taxable under the head "Income from other sources" as it arose from an independent source of income not connected with the construction activities or business activities. The Supreme Court observed that though the Court had very often referred to accounting practice for ascertainment of profits, when the question was whether a receipt of money was taxable or not or whether certain deductions from that receipt were permissible in law or not, the question had to be decided according to the principles of taxation laws and not only in accordance with accountancy practice.

When a similar issue came up before the Supreme Court again in *CIT v. Bokaro Steel Ltd. 236 ITR 315*, the Supreme Court followed the relevant Accounting Standard and held that rent of quarters given to contractors and charges for plant and machinery given to contractors for use in construction work and interest from advances made to contractors for facilitating the construction work should be deducted from the cost of construction on the ground that these receipts were inextricably linked with the setting up of the capital structure of the company and hence should be viewed as capital receipts which would go to reduce the cost of construction.

The concept of deferred revenue expenditure, being an accounting concept, was not initially recognized for the purpose of Income-tax Act. However, in the case of *Madras Industrial Investment Corporation Ltd. v. CIT 225 ITR 802*, the Supreme Court had accepted this concept and held that discount on issue of debentures should be spread over the period of debentures for the purpose of taxation. Further, the Bombay High Court has held, in *CIT v. SM. Holding & Finance (P.) Ltd. (2004) 134 Taxman 328*, that premium on redemption of convertible debentures can be claimed as a deduction over the life of debentures. This case has also recognized the concept of deferred revenue expenditure for income-tax purposes.

The Madhya Pradesh High Court has, in *CIT v. State Bank of Indore (2005) 146 Taxman 65*, observed that the amount of bad debts should be debited to the provision for bad and doubtful debts account and only if such amount is more than the credit balance in the provision for bad and doubtful debts account, the excess is eligible for deduction under section 36(1)(vii). As per generally accepted accounting principles, the allowability of deduction in respect of bad debts is clearly governed by the method of accounting as explained by the High Court in *CIT v. State Bank of Indore.*

The above judicial pronouncements and other similar cases indicate that accounting concepts are now being increasingly recognized for the purpose of tax laws.

12.2 ACCOUNTING STANDARDS AND INCOME-TAX LAW - CONVERGENCE AND DIVERGENCE

Now, we shall study the points of similarity and differences between the principles laid down under the Accounting Standards and income-tax law.

(1) AS-1 [Disclosure of accounting policies]

The CBDT has notified TAS-1 on Disclosure on accounting policies (See para 12.4) which is more or less in line with AS-1 issued by the ICAI. Compliance with this standard is mandatory for assessees following mercantile system of accounting. Further, it may be noted that in the case of corporate assesses, the profit and loss account prepared for section 115JB(2) of the Income-tax Act and annual accounts including profit and loss account prepared and placed before the Annual General Meeting has to be based on the same accounting policies. This is required even if the company adopts a financial year which is different from the previous year under the Income-tax Act.

(2) AS-2 [Valuation of inventories]

(i) AS-2 recognises Exclusive method of inventory valuation whereas section 145A of the Income-tax Act prescribes Inclusive method of inventory valuation. These two methods have been discussed in detail in para 12.5 of this chapter.

(ii) As per this Standard, inventory has to be valued at lower of cost and net realizable value. This method is also recognized for income-tax purposes in case of a going concern. Only in a case where the fundamental accounting assumption of going concern no longer holds good, the closing stock has to be valued at market price. The Supreme Court, in *ALA Firm v. CIT (1991) 189 ITR 285*, held that when a firm is dissolved and the business is discontinued, closing stock taken over by the partner has to be valued at market value and not at cost. The principle involved in this case is that the fundamental accounting assumption of going concern cannot be applied for valuing stock-in-trade at the time of dissolution.

(iii) In *CIT v. British Paints India Ltd. (1991) 188 ITR 044,* the Supreme Court held that while valuing the closing stock of paints, total exclusion of all overheads was not permissible. A reasonable portion of the overheads has to be included. This decision is in accordance with the principles enunciated in AS-2.

(iv) In *Hela Holdings Pvt. Ltd. v. CIT. (2003) 263 ITR 0129*, the Calcutta High Court has held that where the change in the method of valuation of stock effected by the assessee is in accordance with the Accounting Standard and the new method has been followed consistently in the subsequent years, such a change in method would be valid and proper.

(3) AS-4 [Contingencies and events occurring after the balance sheet date]

As per AS-4, events occurring after balance sheet date require adjustment in accounts if they confirm conditions as at balance sheet date *or call into question the assumption of going concern* or such adjustments are statutorily required. Further, even if events do not relate to conditions existing at the balance sheet date, adjustments to assets and liabilities will be required *if they call into question the assumption of going concern*. For income-tax purposes also, the valuation of stock at lower of cost or market value is permitted only if the fundamental assumption of going concern is satisfied. If this assumption fails, the stock has to be valued only at net realizable value. Therefore, the question of whether the assumption of going concern holds good is relevant for income-tax purposes also.

(4) AS-5 [Net profit or loss for the period, prior period items and changes in accounting policies]

TAS-II [Disclosure of prior period and extraordinary items and changes in accounting policies] notified by the Central Government (See para 12.4) , which is in line with AS-5 issued by the ICAI, has to be followed by all assessees following mercantile system of accounting for income-tax purposes.

(5) AS-6 [Depreciation Accounting]

(i) The basis for provision of depreciation as per this Accounting Standard is the estimated useful life of an asset. However, under the Income-tax Act, the useful life of an asset is not relevant. The concept of “block of assets” is applicable and the rates of depreciation are higher under the Income-tax Act with the objective of providing incentive to the assessee. Further, incentive is also provided by way of additional depreciation in respect of new plant and machinery installed by assessees engaged in the manufacture or production of any article or thing.

(ii) The Accounting Standard provides for allowance of depreciation on revalued amount in the case of revaluation. Under Income-tax Act, depreciation is allowed only on the written down value of block of assets. Revaluation is not recognized for income-tax purposes.

(iii) For the purpose of claiming depreciation under section 32, the asset, in respect of which the depreciation is claimed, must have been used for the purpose of business or profession. However, use of asset is not a pre-condition for provision of depreciation under AS-6.

(6) AS-7 [Accounting for construction contracts]

As per AS-7, contract costs comprise, *inter alia*, of costs that are attributable to the contract activity in general and can be allocated to the particular contract. One of the permissible costs which can be included in this category is borrowing costs. The Madras High Court, in *CIT v. S.I. Property Development (P.) Ltd. (2004) 135 Taxman 235*, has applied AS-7 for including interest in project cost for tax purposes.

Further, it appears that the percentage of completion method required to be adopted as per AS-7 will be adequate for tax purposes also.

(7) AS-9 [Revenue Recognition]

This Standard provides that revenue recognition should be postponed if there is significant uncertainty regarding collectibility. This principle has been recognized for tax purposes also by the Supreme Court in the case of *UCO Bank v. CIT 237 ITR 889*, where it was held that interest on sticky loans would not accrue if the same was not recoverable. The recent decision of the Allahabad High Court in *CIT v. U.P. Financial Corporation (2005) 143 Taxman 47* that interest accrual should be postponed where suits for recovery of interest-bearing loans are pending, is also in consonance with this principle enunciated in AS-9.

(8) AS-10 [Accounting for Fixed Assets]

As per this Standard, profit/loss on sale of fixed assets carried at historical cost has to be credited/charged to profit and loss account. As per the Income-tax Act, in respect of sale capital assets, capital gain/loss arises. In case the capital asset is a long term capital asset, benefit of indexation is available and the indexed cost is reduced from the net sale consideration to arrive at the capital gains. In respect of sale of depreciable assets, the entire sale proceeds have to be reduced to arrive at the written down value, where the block continues to exist. In case the block ceases to exist, the resultant figure would be a short-term capital gain/loss. Therefore, under the Income-tax Act, profit/loss on sale of capital assets is not considered as business income/business loss.

(9) AS-11 [Accounting for the effects of changes in foreign exchange rates]

As per AS-11, exchange differences relating to a liability incurred for the purpose of acquiring fixed assets, which are carried in terms of historical cost, cannot be adjusted in the carrying amount of the respective fixed assets. The exchange difference has to be charged to profit and loss account. However, section 43A of Income-tax Act requires such exchange differences to be adjusted against the actual cost of the asset. Such

adjustment has to be made in the year in which the actual payment is made irrespective of the method of accounting followed by the assessee.

However, it may be noted that in the case of companies, the exchange difference relating to acquisition of a depreciable capital asset can be adjusted against the cost of the asset, at the option of the enterprise. This treatment can be done in respect of accounting periods between 7th December, 2006 and 31st March, 2011 [Notification No. G.S.R. 225 (E) dated 31.3.2009].

(10) AS-12 [Accounting for Government Grants]

This Standard provides that the accounting treatment would depend on the nature and purpose of the grant. The Madhya Pradesh High Court, in *Shreejee Chitra Mandir v. CIT (2004) 275 ITR 055,* observed that the question of whether a particular subsidy is a capital receipt or a revenue receipt for income-tax purposes has to be decided keeping in view the nature of subsidy received by the assessee, and the scheme pursuant to which the same has been received. In other words, it is obligatory upon the taxing authorities to examine the nature of subsidy and the object of the scheme pursuant to which it has been received by the assessee, before they record a finding one way or the other. This decision is in consonance with AS-12.

(11) AS-13 [Accounting for Investments]

As per this Standard, long-term investments should be carried at cost and provision should be made to recognize a decline other than temporary in the value of long-term investments. Such reduction should be determined and made for each investment individually. However, under the Income-tax Act, there is no provision to recognize a decline in the value of investments. Only if the investments are disposed off, the profit/loss on account of the same is recognized. In *Kerala Small Industries Development Corporation Ltd. v. CIT (2004) 270 ITR 0452*, the assessee had written off Rs.80 lakhs, representing investment in shares of co-operative societies, in its profit and loss account considering the fact that the said co-operative societies were either defunct or under liquidation. The High Court observed that any loss on shares representing investment of the assessee cannot be termed as trading/revenue loss. Further, the High Court observed that the reduction in the value of shares was effected through book entries only and there was no actual transfer of shares. Therefore, it could not even be construed as a capital loss arising out of trading in capital assets.

(12) AS-14 [Accounting for Amalgamations]

As per this Standard, amalgamation expenses incurred by the transferee company should be debited to profit and loss account where the amalgamation is in the nature of merger and to Goodwill/Capital reserve account where the amalgamation is in the nature of purchase. Under section 35DD of the Income-tax Act, deduction of one-fifth of such expenditure is allowed for five successive previous years, beginning with the previous

year in which amalgamation takes place. Further, the Income-tax Act does not distinguish between amalgamation in the nature of merger and amalgamation in the nature of purchase.

(13) AS-15 [Accounting for Retirement Benefits]

The accrual basis (matching concept) of accounting is prescribed under this Accounting Standard for accounting of retirement benefits like provident fund and gratuity. However, as per section 43B of the Income-tax Act, deduction is allowable only on the basis of actual payment in respect of employer's contribution to any provident fund or superannuation fund or gratuity fund or any other fund for the welfare of employees. The assessee should have actually paid these amounts on or before the due date for furnishing the return of income under section 139(1) to claim the deduction during the previous year of accrual.

(14) AS-16 [Borrowing Costs]

As per this Standard, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized as part of the cost of that asset. Qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale e.g. manufacturing plants, power generation facilities. Other borrowing costs should be recognized as an expense in the period in which they are incurred and charged off to profit and loss account.

Under the Income-tax Act, interest in respect of capital borrowed (for acquisition of a new asset for expansion of existing business or profession) for any period from the date of borrowal to the date on which the asset was first put to use should be capitalized. *Explanation* 8 to section 43(1) clarifies that interest relatable to a period after the asset is first put to use cannot be capitalized. Such interest would be allowed as deduction under section 36(1), if the capital is borrowed for the purposes of business or profession.

Thus, while the accounting treatment for interest depends on whether it is incurred in respect of a qualifying asset or other asset, the tax treatment depends upon –

(i) whether the interest relates to the period before the asset is first put to use or after; and

(ii) whether the capital is borrowed for the purposes of business or profession.

(15) AS-18 [Related Party Disclosures]

This Standard prescribes disclosure of related party relationships and transactions between a reporting enterprise and its related parties. It does not prescribe any accounting requirement. However, under the Income-tax Act, a specific disallowance has been provided. Under section 40A(2), where the assessee incurs any expenditure in respect of which a payment has been or is to be made to a relative or associate concern,

so much of the expenditure as is considered to be excessive or unreasonable shall be disallowed by the Assessing Officer. Further, transfer pricing provisions have been introduced by the Finance Act, 2001 to provide for application of "arm's length price" for determining the income from an international transaction with an associated enterprise. Arm's length price is the price which is applied or proposed to be applied in a transaction between persons other than associated enterprises in uncontrolled conditions.

(16) AS-19 [Leases]

The leases are classified into finance leases and operating leases as per this Standard. A finance lease is a lease that transfers substantially all risks and rewards incident to ownership of an asset. In operating lease, only the right to use the asset is transferred. Depreciation on leased asset is allowable as per AS-6 in the hands of the lessee in case of a finance lease. However, this Accounting Standard will have no implication on the allowance of depreciation on assets under the provisions of the Income-tax Act. The owner of the asset (i.e. the lessor) is entitled to depreciation under section 32 of the Income-tax Act, if the asset is used in his business. This has been clarified by CBDT Circular No.2 dated 9.2.2001.

Lease rentals from finance lease are apportioned between finance income and reduction of lease receivable outstanding in the books of the lessor as per AS-19. Only finance income is credited to the profit and loss account whereas the full lease rental is treated as income for tax purposes. Similarly, in the books of the lessee, lease rental is apprortioned between finance charges and reduction of liability. Only the finance charges are debited to the profit and loss account whereas the full lease rental is deductible for tax purposes.

As per AS-19, lease income from operating leases should be recognized in the profit and loss account on a straight line basis over the lease term even if the receipts are not on such basis. However, for income-tax purposes, such lease income is recognized on cash/mercantile basis, depending on the method of accounting regularly followed by the assessee.

(17) AS-28 [Impairment of assets]

As per this Standard, if the carrying amount of an asset exceeds its recoverable value, the excess is impairment loss. Such loss should be provided for in the statement of profit and loss. It must be noted that impairment provision is in addition to the depreciation provided as per AS-6. However, there is no such provision for impairment loss under the income-tax law.

(18) AS-29 [Provisions, Contingent liabilities and Contingent assets]

This Standard, *inter alia,* requires only disclosure of contingent liabilities. It does not require recognition of the same in the profit and loss account. It has been specifically

given that no provision should be made in the books for contingent liabilities. This is in concurrence with the income-tax provisions, since contingent liabilities are not recognized for income-tax purposes also.

12.3 TREATMENT OF INCOME-TAX EXPENSE UNDER ACCOUNTING STANDARDS

AS-3, AS-22 and AS-25 provide for the accounting treatment of income-tax expense. In particular, AS-22 on "Accounting for taxes on income" is very important in this regard and hence has been discussed in some length. Let us try to understand the accounting treatment of income-tax expense as per these Standards.

(1) AS-3 [Cash flow statement]

As per this Standard, cash flow on account of income-tax has to be shown as an operating activity unless it can be specifically identified with an investing or financing activity. If income-tax paid is segregated between these activities, then total tax paid should also be disclosed. Income-tax paid should be shown net of TDS.

(2) AS-22 [Accounting for taxes on income]

Accounting for taxes on income should be in accordance with AS-22, irrespective of whether such taxes are imposed by an Indian law or by the law of a foreign country. Prior to AS-22, corporates were making a provision for the actual tax liability calculated in accordance with the Income-tax Act, 1961(i.e., current tax). The accounting effect for differences between taxable income and accounting income was not given. In the case of a loss-making entity, no provision for taxation was made. Neither was any entry passed for accounting for tax savings as a result of the loss. However, such treatment is not permitted under AS-22. As per AS-22, the amount to be included in respect of income tax in the profit and loss account should be the current tax plus or minus the deferred tax.

Current tax is the tax determined in accordance with the provisions of the Income-tax Act, 1961. Deferred tax is the tax effect of timing differences. There is always a difference between the accounting income and the taxable income. AS-22 requires classification of these differences into permanent differences and timing differences.

Permanent differences

Permanent differences are those differences which originate in one period and do not reverse subsequently. These differences will not at all reverse in subsequent periods. These differences do **not** result in deferred tax assets (DTAs) or deferred tax liabilities (DTLs). Such differences are on account of -

(i) Recognition of revenues/gains/expenses/loses in the profit and loss account but not for income-tax computation. One example is goodwill, which is amortised in accounts. However, the same is not a deductible expense while computing income-tax. Another example is unrealised exchange gain, which is credited to profit and loss account but not taxed as income.

(ii) Recognition of revenues/gains/expenses/losses for income-tax purposes but not in the profit and loss account for accounting purposes. One example is expenditure in

respect of which weighted deduction is allowable under the Income-tax Act, namely, contribution made for research in social science or statistical research or any other research, which is eligible for a deduction of 125% under section 35 of the Income-tax Act. The excess deduction 25% is not recognized in the profit and loss account but considered for computation of taxable income.

It may be noted that no accounting adjustments are necessary for tax effects of permanent differences.

Timing differences

Timing differences are the differences between the accounting income and the taxable income that originate in one period and are capable of reversal in one or more subsequent periods. The words 'capable of reversal' means that there are chances of reversal, however good or remote they may be. It does not, however, indicate 100 per cent certainty of reversal.

Timing differences arise only in respect of incomes/expenses which are considered both in the profit and loss account as well as for computation of taxable income, although, in different periods. Some examples of timing differences are given below -

(1) Expenses debited to profit and loss account but allowed for tax purposes in subsequent years, for example -

(i) Expenditure covered by section 43B of the Income-tax Act, which are allowed only in the year of actual payment. However, in the previous year in which the expenditure is incurred, it can be claimed as deduction, provided it is paid on or before the due date for filing the return of income.

(ii) Any interest, royalty, fees for technical services payable outside India or in India to a non-resident, on which tax has not been deducted at source and hence disallowed during the previous year. However, the same has been allowed for tax purposes in the subsequent year when such tax is deducted and paid.

(iii) Any interest, commission or brokerage, fees for professional services or fees for technical services payable to a resident, on which tax has not been deducted at source and hence disallowed during the previous year. However, the same has been allowed in the subsequent year when such tax is deducted and paid.

(iv) Provisions made for liabilities in the books of account. However, deduction is allowed under the Income-tax Act in the subsequent years when the liability crystallizes e.g., provision for warranties.

(v) Preliminary expense written off completely in the year in which they are incurred as per AS-26 but allowed to be amortised over 5 years for tax purposes as per section 35D.

(2) Difference between depreciation as per books of account and depreciation allowable for tax purposes under section 32.

(3) A deduction which is allowed for tax purposes on the basis of a deposit made, for example, tea/coffee/rubber development account scheme under section 33AB and site restoration fund under section 33ABA. The withdrawal from such deposit is debited to the profit and loss account in the subsequent years.

(4) Income credited to profit and loss account in a particular year but brought to tax in a later year. For example, where a capital asset is converted into stock in trade, the capital gains would be charged to tax only in the previous year in which the stock in trade is sold.

A timing difference may result in a deferred tax asset or a deferred tax liability.

A deferred tax asset arises on account of –

(i) Recognition of revenue/gain in an earlier period for tax purpose, but in a later period for accounting purpose.

e.g. operating lease rentals, in a case where the amount received in an earlier year is high, the same would be recognized as income for tax purpose. However, for accounting purpose, the recognition would be deferred since such lease rentals are recognized on a straight line basis as per AS-19.

(ii) Recognition of expenses/losses in an earlier period for accounting purpose, but in a later period for tax purpose.

e.g. (i) Expenditure in relation to which section 43B applies, in respect of which payments have not been made on or before the due date for filing the return of income. Such expenditure will be allowed for tax purposes in the year of actual payment.

(ii) Preliminary expenses written off during the year in the profit and loss account but deferred over a period of 5 years for tax purposes as per section 35D.

A deferred tax liability arises on account of -

(i) Recognition of revenue/gain in an earlier period for accounting purpose, but in a later period for tax purpose -

e.g. conversion of a capital asset into stock-in trade – recognized in the year of conversion for accounting purpose but only in the year of sale of stock-in-trade for tax purpose.

(ii) Recognition of expenses/losses in an earlier period for tax purpose, but in a later period for accounting purpose -

e.g. Depreciation, since the tax depreciation is higher than the depreciation as per accounting books on account of the higher rates of depreciation under the Income-tax Act.

12.12 Income Tax

The tax effect of timing difference i.e. deferred tax should be treated in the following manner –

(i) the deferred tax should form part of the tax expenses in the profit and loss account; and

(ii) it should be accounted as a deferred tax asset (DTA)/deferred tax liability (DTL) in the balance sheet.

The criteria for recognizing DTAs are -

(i) In a case where there are unabsorbed losses/deprecation under the tax laws –

DTA should be recognized only to the extent there is virtual certainty supported by convincing evidence that adequate future taxable income will be available against which DTAs can be realised. Virtual certainty means certain for all practical purposes. Mere forecasts of performance would not satisfy this criterion. Further, virtual certainty is not a matter of perception. It has to be backed up by convincing evidence i.e. evidence available at the reporting date in concrete form e.g. a profitable binding export order, cancellation of which would attract high penalty in the hands of the defaulting person. Future profitability projections would not, in isolation, be taken as convincing evidence, even though they may be submitted to an outside agency like a bank and accepted by them.

(ii) In any other case (i.e. where there are no unabsorbed losses/depreciation under tax laws) –

DTA should be recognized and carried forward only to the extent there is reasonable certainty that adequate future taxable income would be available against which DTAs can be realised.

Accounting treatment for DTA

The accounting treatment for DTA is as shown hereunder -

(i) Entry to be passed in the year in which timing difference originates -

DTA A/c Dr.

To Profit and Loss A/c

(This is the entry to be passed when the DTA is recognized on meeting the virtual certainty/reasonable certainty criteria, as the case may be. The amount to be debited to the DTA a/c and credited to the profit and loss A/c is the amount arrived at by multiplying the timing difference with the tax rate applicable for the year)

(ii) Entry to be passed in the subsequent years -

The carrying amount of DTAs has to be reviewed at each balance sheet date. The carrying amount of a DTA has to be written down to the extent that it is no longer

reasonably certain or virtually certain, as the case may be, that adequate future taxable income would be available to realize the DTA. Reversal of a previous write-down may be done to the extent it becomes reasonably certain or virtually certain, as the case may be, that adequate future taxable income would be available.

Therefore, in the subsequent years, there should be a review as to whether the recognition criteria is met. If the same is not met, the entire balance should be written off. If the recognition criteria is met, the closing balance of DTA has to be valued applying the tax rate for that year on the unreversed timing difference. The unreversed timing difference is the difference between the timing difference at the beginning of the financial year and the reversal during the year.

Profit and Loss A/c Dr.

To DTA A/c

(This is the entry to be passed in the subsequent years to account for the difference between the opening and closing balance in the DTA a/c which represents reversal of timing difference during the year)

Let us understand these entries with the help of an example –

XYZ Ltd., a domestic company, prepares its accounts on 31st March every year. The company has incurred a loss of Rs.5,00,000 during the year ended 31.3.2009 and made profits of Rs.3,00,000 and Rs.3,50,000 during the years 2009-10 and 2010-11, respectively. The rate of income-tax applicable to the company for all the three assessment years (i.e. A.Y.2009-10, A.Y.2010-11 & A.Y.2011-12) is 30% plus education cess@2% plus secondary and higher education cess@1%. Surcharge@ 10% would not be applicable since the total income does not exceed Rs.1 crore. The business loss can be carried forward for 8 years. On 31.3.2009, it was virtually certain, supported by convincing evidence, that the company would have adequate taxable income in the future years against which unabsorbed losses can be set-off. You are required to pass accounting entries assuming that there is no other difference between taxable income and accounting income.

Profit and loss account for the years ended

Particulars	31.3.2009	31.3.2010	31.3.2011
Profit/Loss before giving effect to tax	(5,00,000)	3,00,000	3,50,000
Current tax @ 30.9% of Rs.1,50,000			(46,350)
Deferred tax			
- Tax effect of timing differences originating during the year [5,00,000 × 30.9%]	1,54,500		

12.14 Income Tax

- Tax effect of timing differences reversing during the year ending -			
31.3.2010 – [3,00,000 × 30.9%]		(92,700)	
31.3.2011 – [2,00,000 × 30.9%]			(61,800)
Profit/Loss after giving effect to tax	**(3,45,500)**	**2,07,300**	**2,41,850**

Entry to be passed for the year ending 31.3.2009

DTA A/c Dr 1,54,500

To Profit and loss A/c 1,54,500

(DTA on account of tax saving due to carry forward of losses)

Entry to be passed for the year ending 31.3.2010

Profit and loss A/c Dr 92,700

To DTA A/c 92,700

(Reversal of DTA on account of set-off of brought forward loss against current year income)

Entry to be passed for the year ending 31.3.2011

Profit and loss A/c Dr 61,800

To DTA A/c 61,800

(Reversal of DTA on account of set-off of brought forward loss against current year income)

Accounting treatment for DTL

The accounting treatment for DTL is as shown hereunder -

(i) Entry to be passed in the year in which timing difference originates -

Profit and Loss A/c Dr.

To DTL A/c

(This is the entry to be passed when the DTL is recognized. The amount to be credited to the DTL A/c and debited to the profit and loss account is the amount arrived at by multiplying the timing difference with the tax rate applicable for the year)

(ii) Entry to be passed in the subsequent years -

DTL A/c Dr.

To Profit and Loss A/c

(This is the entry to be passed in the subsequent years to account for the difference between the opening and closing balance in the DTL A/c which represents reversal of timing difference during the year. For arriving at the closing balance, the unreversed timing difference should be multiplied by the tax rate applicable for that year)

(3) AS-25 [Interim Financial Reporting]

The Council of the ICAI has issued a Guidance Note [GN(A) 24] on Measurement of Income-tax expense for Interim Financial Reporting in the context of AS-25. The steps to be followed for measurement of income-tax expenses for the purpose of interim financial reports have been clearly explained in this Guidance Note.

(1) First of all, let us understand the general principles for recognition and measurement laid down in AS 25, which are briefed hereunder -

(i) An enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements.

(ii) However, the frequency of an enterprise's reporting (annual, half-yearly, or quarterly) should not affect the measurement of its annual results. In order to achieve this objective, measurements for interim reporting purposes should be made on a year-to-date basis.

(iii) The requirement that an enterprise should apply the same accounting policies in its interim financial statements as in its annual financial statements may seem to suggest that interim period measurements are made as if each interim period stands alone as an independent reporting period. However, by providing that the frequency of an enterprise's reporting should not affect the measurement of its annual results, it has been acknowledged that an interim period is a part of a financial year.

(iv) Year-to-date measurements may involve changes in estimates of amounts reported in prior interim periods of the current financial year.

(v) However, the principles for recognising assets, liabilities, income, and expenses for interim periods should be the same as in annual financial statements.

(2) Paragraph 29(c) of AS 25 illustrates the application of the general principles for recognition and measurement of tax expense in interim periods. As per this Paragraph, income tax expense should be recognised in each interim period based on the best estimate of the weighted average annual income-tax rate expected for the full financial year. Amounts accrued for income-tax expense in one interim period may have to be adjusted in a subsequent interim period of that financial year if the estimate of the annual

income tax rate changes.

(3) Appendix 3 to AS 25 illustrates the general recognition and measurement principles for the preparation of interim financial reports. Paragraphs 8 to 16 of the Appendix provide guidance on the computation of income-tax expense for the interim period. As per Paragraph 8 of the Appendix, interim period income-tax expense has to be accrued using the tax rate that would be applicable to the expected total annual earnings, that is, the estimated average annual effective income tax rate applied to the pre-tax income of the interim period.

(4) The various steps involved in the measurement of income-tax expense for the purpose of interim financial reports are as below:

(i) An enterprise will first have to estimate its annual accounting income. For this purpose, an enterprise would have to take into account all probable events and transactions that are expected to occur during the financial year. Such an estimate would involve, for example, estimating on prudent basis, the depreciation on expected expenditure on acquisition of fixed assets, profits from sale of fixed assets/investments, etc. Such future events and transactions should be taken into account only if there is a reasonable certainty that the same would take place during the financial year.

(ii) The enterprise should next estimate its tax liability for the financial year. For this purpose, the enterprise will have to estimate taxable income for the year. By applying the enacted or the substantively enacted tax rate on the taxable income, an estimate of the current tax for the year is arrived at. The estimates of tax liability would have to be based on the estimated deductions, allowances, etc., that would be available to the enterprise, provided there is a reasonable certainty for the same. The enterprise would also have to estimate the deferred tax assets/liabilities by applying the principles of AS 22 on 'Accounting for taxes on Income'. Special considerations may have to be applied in certain cases as below:

(a) Where brought forward losses exist from the previous financial year (when deferred tax asset was not recognised on considerations of prudence as per AS 22): In such a situation, for estimating the current tax liability, the brought forward losses would have to be deducted from the estimated annual accounting income. Since such brought forward losses will get set-off during the year, these would not have any tax consequence in future periods.

(b) Where brought forward losses exist (when deferred tax asset was recognised on the considerations of prudence as per AS 22): In such a situation, current tax would be computed in the same manner as explained in (a) above. However, for determination of deferred tax, the tax expense arising from the reversal of the deferred tax asset recognised previously, to the extent of reversal of deferred tax asset in the current year, would also be considered.

(iii) The enterprise would now have to calculate the weighted average annual effective tax rate. This tax rate would be determined by dividing the estimated tax expense as

arrived at step (ii) above by the estimated annual accounting income as arrived at in step (i) above. Where different tax rates are applicable to different portions of the estimated annual accounting income, e.g., normal tax rate and a different tax rate for capital gains, the weighted average annual effective tax rate would have to be calculated separately for such portions of estimated annual accounting income.

(iv) The weighted average annual effective tax rate arrived at step (iii) would be applied to the accounting income for the interim period for determining the income-tax expense to be recognised in the interim financial reports.

(5) Accounting for interim period income-tax expense as suggested above is based on the approach prescribed in AS 25 that the interim period is part of the whole accounting year and, therefore, the said expense should be worked out on the basis of the estimated weighted average annual effective income-tax rate. This approach is called the "integral approach". According to this approach, the said rate is determined on the basis of the taxable income for the whole year, and applied to the accounting income for the interim period in order to determine the amount of tax expense for that interim period. This is in contrast to accounting for certain other expenses such as depreciation which is based on the approach prescribed in AS 25 that the interim period should be considered on stand-alone basis because expenses such as depreciation are worked out on the basis of the period for which a fixed asset was available for use. This approach is called the 'discrete approach'. The aforesaid treatments are, however, consistent with the requirement contained in paragraph 27 of AS 25 that an enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements.

12.4 RELEVANCE OF METHOD OF ACCOUNTING UNDER THE INCOME-TAX ACT

Having studied the areas of convergence and divergence between Accounting Standards and income-tax laws and how income-tax expense is dealt with in the Accounting Standards, let us proceed to study how the method of accounting assumes importance under the Income-tax Act, 1961.

Section 145 of the Income-tax Act deals with the 'Method of Accounting'. This section provides that the income chargeable under the head "Profits and gains of business or profession" and "Income from other sources" have to be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee (It may be noted that the hybrid method is not permitted under the Income-tax Act). Therefore, the method of accounting is not relevant in computing income under the heads "Salaries", "Income from house property" and "Capital gains". The income under these heads have to be computed solely on the basis of the provisions contained in the Income-tax Act. Even in the case of the two heads of income where this section applies *i.e.,* profits and gains of business or profession and income from other sources, wherever specific provisions are made for inclusion of particular income or for disallowance of

particular expenditure on cash or accrual basis, then income shall be so computed irrespective of the method of accounting employed. For example, as per section 43B, certain expenditure like taxes, duties etc. are allowable only in the year of payment, irrespective of the previous year in which the liability to pay such sum arose according to the method of accounting regularly employed by the assessee. However, in the case of an assessee following mercantile system of accounting, such expenditure can be claimed as deduction on "due" basis provided the payment has been made on or before the due date of furnishing the return of income.

The assessee is also required to follow the Accounting Standards notified by the Central Government. The Central Government may notify in the Official Gazette, from time to time, Accounting Standards to be followed by any class of assesses or in respect of any class of income. The Government has, so far, notified two Accounting Standards (TASs) to be followed by all assesses following mercantile system of accounting. Accounting Standard I (TAS I) is on "Disclosure of Accounting policies" and Accounting Standard II (TAS II) is on "Disclosure of prior period and extraordinary items and changes in accounting policies". These standards are more or less on the same pattern as AS-1 and AS-5 issued by the ICAI.

TAS I [Disclosure of Accounting Policies]

This standard requires disclosure of all significant accounting policies adopted in the preparation and presentation of financial statements. The disclosure of the significant accounting policies should form part of the financial statements. Further, all significant accounting policies should normally be disclosed in one place.

Disclosure of any change in an accounting policy, which has a material effect in the previous year or in the years subsequent to the previous years, is required. Further, the impact of, and the adjustments resulting from, such change, if material, is required to be shown in the financial statements of the period in which such change is made to reflect the effect of such change. In case the effect of such change is not ascertainable, wholly or in the part, the same should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the previous year but which is reasonably expected to have a material effect in any year subsequent to previous year, the fact of such change is required be appropriately disclosed in the previous year in which the change is adopted.

Accounting policies adopted by an assessee should be such as to represent a true and fair view of the state of affairs of the business, profession or vocation in the financial statements prepared and presented on the basis of such accounting policies. For this purpose, the significant accounting considerations governing the selection and application of accounting policies are following, namely:—

(i) **Prudence:** Provisions should be made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information;

(ii) **Substance over form:** The accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely by the legal form;

(iii) **Materiality:** Financial statements should disclose all material items, the knowledge of which might influence the decision of the users of the financial statements.

If the fundamental accounting assumptions relating to Going Concern, Consistency and Accrual are followed in financial statements, specific disclosure in respect of such assumptions is not required. If a fundamental accounting assumption is not followed, such fact should be disclosed.

Meaning of the terms used in this standard

(a) "Accounting policies" means the specific accounting principles and the methods of applying those principles adopted by the assessee in the preparation and presentation of financial statements;

(b) "Accrual" refers to the assumption that revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate;

(c) "Consistency" refers to the assumption that accounting policies are consistent from one period to another;

(d) "Financial Statements" means any statement to provide information about the financial position, performance and changes in the financial position of an assessee and includes balance sheet, profit and loss account and other statements and explanatory notes forming part thereof;

(e) "Going concern" refers to the assumption that the assessee has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the business, profession or vocation and intends to continue his business, profession or vocation for the foreseeable future.

TAS II [Disclosure of Prior Period and Extraordinary items and Changes in Accounting Policies]

This standard requires separate disclosure of prior period items in the profit and loss account in the previous year, along with their nature and amount, in a manner so that their impact on profit or loss in the previous year can be perceived.

Similarly, disclosure of extraordinary items of the enterprise during the previous year as part of the income in the profit and loss account is required. The nature and amount of each such item should be separately disclosed in a manner so that their relative significance and effect on the operating results of the previous year can be perceived.

12.20 Income Tax

This standard imposes a condition that a change in an accounting policy should be resorted to only if the adoption of a different accounting policy is required by statute or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements by assessee.

Any change in an accounting policy which has a material effect is required to be disclosed. The impact of, and the adjustments resulting from such change, if material, has to be shown in the financial statements of the period in which such change is made to reflect the effect of such change. Where the effect of such change is not ascertainable, wholly or in part, the same should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the previous year but which is reasonably expected to have a material effect in years subsequent to the previous years, the fact of such change has to be appropriately disclosed in the previous year in which the change is adopted.

A change in an accounting estimate that has a material effect in previous year has to be disclosed and quantified. Further, any change in an accounting estimate which is reasonably expected to have a material effect in years subsequent to the previous year shall also be disclosed. If a question arises as to whether a change is a change in accounting policy or a change in an accounting estimate, such a question has to be referred to the CBDT for decision.

Meaning of the terms used in this standard

(a) "Accounting estimate" means an estimate made for the purpose of preparation of financial statements which is based on the circumstances existing at the time when the financial statements are prepared;

(b) "Accounting policies" means the specific accounting principles and the method of applying those principles adopted by the assessee in the preparation and presentation of financial statements;

(c) "Extraordinary items" means gains or losses which arise from events or transactions which are distinct from the ordinary activities of the business and which are both material and expected not to recur frequently or regularly. Extraordinary items includes material adjustments necessitated by circumstances which though related to years preceding to the previous years are determined in the previous year;

However, the income or expenses arising from the ordinary activities of the business or profession or vocation of an assessee, though abnormal in amount or infrequent in occurrence, will not qualify as extraordinary item;

(d) "Financial Statements" means any statement to provide information about the financial position, performance and changes in the financial position of an assessee and includes balance sheet, profit and loss account and other statements and explanatory notes forming part thereof;

(e) "Prior period items" means material charges or credits which arise in the previous year as a result of errors or omissions in the preparation of the financial statements of one or more previous years; However, the charge or credit arising on the outcome of a contingency, which at the time of occurrence could not be estimated accurately will not constitute the correction of an error but a change in estimate and such an item will not be treated as a prior period item.

Therefore, TAS-I and TAS-II, which are on the lines of AS-1 and AS-5 issued by the ICAI, have been specifically recognized under the Income-tax Act. These accounting standards have to be followed by all assessees following mercantile system of accounting.

Best Judgement Assessment

Where the Assessing Officer is not satisfied about the correctness or completeness of the accounts of the assessee or where the method of accounting or accounting standards have not been regularly followed by the assessee, the Assessing Officer may make an assessment in the manner provided in section 144. The assessment made under section 144 is known as "Best Judgement Assessment" as the Assessing Officer, in spite of non-compliance and non-co-operation of the assessee, is expected to make the assessment to the best of his judgement.

***Bona fide* change in the method of accounting**

It is open to the assessee to make a change in the method of accounting if the change does not involve any *mala fide* motive and the assessee regularly follows the changed method of accounting. However, the change should not result in adoption of hybrid method of accounting.

The Supreme Court held, by a majority judgement in *State Bank of Travancore vs. C.I. T. (1985) 50 CTR 290 (SC),* that in the case of a bank following mercantile basis of accounting, it is the income which has really accrued or arisen to the assessee that is taxable. Whether the income has really accrued or arisen to the assessee must be judged in the light of the reality of the situation. The concept of real income would apply where there has been a surrender of income, which, in theory may have accrued but in the reality of the situation no income had resulted because the income did not really accrue. Where a debt has become bad, deduction can be claimed after complying with the provisions of the Act. Where the Act applies, the concept of real income should not be so read as to defeat the provisions of the Act. The conduct of the parties in treating the income in a particular manner is material evidence of the fact whether income has accrued or not. Mere improbability of recovery, where the conduct of the assessee is

unequivocal, cannot be treated as the evidence of the fact that income has not resulted or accrued to the assessee.

In view of this matter, the Supreme Court held that interest on sticky advance being doubtful of recovery, which had accrued legally to the assessee (in this case a banking institution following the mercantile system of accounting) could not be kept out of the net of taxation by crediting the said amount to a separate account styled as 'Interest Suspense Account'. The Supreme Court, by a majority judgement, held that after debiting the debtor's account and not reversing that entry, but merely taking the interest to a suspense account, could not be taken as evidence to show that no real income had accrued to the assessee or treated as such by the assessee.

An assessee is entitled to change his regular method of accounting by another regular method *[Snow White Food Products Co. Ltd. vs. CIT (No. 2) (1983) 141 ITR 847]*. Where it is found that if an assessee has changed his regular method of accounting by another recognised method and has followed the latter method regularly thereafter it is not open to the revenue authorities to go into the question of *bonafides* of the introduction and continuance of the change. Only in the year where a change in the method of accounting is introduced for the first time, it is to be examined by the revenue authorities, whether the change introduced was meant to be regularly followed. The Calcutta High Court held, in *Seth Chemical Works vs. C.I.T. (1983) 140 ITR 507,* that where an assessee is allowed to change his method of accounting from an assessment year, he has to compute his income on the changed basis only and not on the old basis.

Stock valuation method adopted should not only be consistent but should also be correct for being accepted by tax authorities. The Supreme Court, in *CIT v. British Paints (India) Ltd. (188) ITR 44*, held that the Assessing Officer is empowered to substitute the correct method in the place of the wrong method adopted by the assessee in valuing closing stock. The Court observed that the wrong method cannot be accepted just because it was consistently followed. Therefore, the Court held that the Assessing Officer was justified in substituting the incorrect method by a correct method.

In *CIT vs. Carborundum Universal Limited (1984) 149 ITR 759,* the company was regularly valuing its stock under total cost method, which excluded certain expenses which were to be included under the former method. The change was *bona fide* and was intended to be followed by the company consistently in the future. The company wanted to apply the new method in the first year of adoption for the valuation of closing stock only and retain the valuation of opening stock of the relevant year as per the old method. This was of course detrimental to the revenue in that year. The question as to whether the company could do so went before the Madras High Court. It was held that (i) since the change in the method of valuation of stock was *bona fide* and intended to be followed year after year, the company was entitled to change the method of valuation, (ii) merely because the change was detrimental to the revenue, the assessee could not be denied the right to change, since this detriment would be ironed out in the coming years, (iii) if the assessee was

forced to apply the new method of valuation to the opening stock then also it will mean change in the valuation of previous year's closing stock and so on necessitating modification of earlier assessments. This in effect would mean that the assessee would not be able to change the method at all, (iv) so long as the method of valuation adopted by the assessee got recognition from the practising accountants and the commercial world, the adoption of that method could not be quashed by the revenue unless the adoption of that method was found to be not *bona fide* or restricted for a particular year.

12.5 VALUATION OF INVENTORY [SECTION 145A vs. AS-2]

As per section 145A of the Income-tax Act, the valuation of purchase and sale of goods and inventory for the purposes of determining the income chargeable under the head "Profits and gains of business or profession" has to be-

a) in accordance with the method of accounting regularly employed by the assessee; and

b) further adjusted to include the amount of any tax, duty, cess or fee, by whatever name called, actually paid or incurred by the assessee to bring the goods to the place of its location and condition as on the date of valuation.

The intention of section 145A is to ensure that the sale of goods and purchase of goods are grossed up by including the excise duty, tax, cess, etc., Inventory should also be grossed up in the same manner. However, the CENVAT credit, if any available towards such duty paid should not be taken into account.

There are two methods for accounting of tax, duty etc. while preparing accounts. They are the Inclusive method and the Exclusive method. Under the Inclusive method, the amounts are grossed up whereas under the Exclusive method, the figures are shown net of CENVAT credit. Section 145A requires assessees to follow only the Inclusive method, whereas AS-2 on "Valuation of Inventories" requires adoption of Exclusive method. Let us try to understand the effect of following the inclusive method and exclusive method with the help of an example –

Particulars	Amount
Opening stock of raw material	Nil
Cost of raw material purchased inclusive of CENVAT credit	5,00,000
CENVAT credit available	20,000
Excise duty (Gross)	35,000
Manufacturing expenses	15,000
Sale value of finished goods	6,25,000
Closing stock of raw material	15% of purchases

TRADING ACCOUNT

[Where Inclusive method is adopted as per the requirement of section 145A]

	Rs.		Rs.
To Raw material consumed		By Sales	6,25,000
Raw material purchased	5,00,000		
Less: Closing stock of raw materials	75,000		
	4,25,000		
To Manufacturing expenses	15,000		
To Excise duty (35,000 – 20,000)	15,000		
To Gross profit	1,70,000		
	6,25,000		**6,25,000**

TRADING ACCOUNT

[Where Exclusive method is adopted as per the requirement of AS-2]

	Rs.		Rs.
To Raw material consumed		By Sales	6,25,000
Raw material purchased	4,80,000		
Less: Closing stock of raw materials	72,000		
	4,08,000		
To Manufacturing expenses	15,000		
To Excise duty	35,000		
To Gross profit	1,67,000		
	6,25,000		**6,25,000**

Section 145A requires the assesses to follow the Inclusive method, which results in higher profits. However, it is significant to note that if a higher value of closing stock is shown in a particular year, the same will be the opening stock in the next year. Therefore, the increase in profits in one year would be compensated by a reduction in profits in the subsequent year. In short, the effect of adopting the inclusive method under section 145A would be to prepone the booking of profits to the preceding year. The tax collection would also be preponed resulting in earlier accrual of revenue to the Government. This would happen in a case where there is a progressive increase in the closing stock every year.

Under the Inclusive method, in the example given above, the closing stock is shown at Rs.75,000 and the excise duty claim of Rs.35,000 is reduced by the entire CENVAT credit

of Rs.20,000 available. If CENVAT credit is availed by the assessee only to the extent of consumption of raw material, the net effect would be the same. The excise duty of Rs.3,000 (being 4% of Closing Stock of Rs.75,000) attributable to closing stock is included in the closing stock value. Therefore, a sum of Rs.17,000 attributable to raw material consumed (being 4% of raw material consumed of Rs.4,25,000) should be reduced from Rs.35,000. This would facilitate the assessee to get a deduction of Rs.18,000/- towards the excise duty for this year. In such a case, the gross profit will be Rs.1,67,000/- which is same as arrived at by following the Exclusive method recommended by AS-2. The Guidance Note on Tax Audit under section 44AB has suggested this approach. Section 145A becomes tax neutral if this approach is adopted. This is explained in the computation shown hereunder -

TRADING ACCOUNT

[Where Inclusive method is adopted]

	Rs.		Rs.
To Raw material consumed		By Sales	6,25,000
Raw material purchased	5,00,000		
Less: Closing stock of raw materials	75,000		
	4,25,000		
To Manufacturing expenses	15,000		
To Excise duty (35,000 – 17,000)	18,000		
To Gross profit	1,67,000		
	6,25,000		**6,25,000**

12.6 REQUIREMENT OF COMPULSORY MAINTENANCE OF PRESCRIBED BOOKS OF ACCOUNT UNDER THE INCOME-TAX LAW [SECTION 44AA]

Section 44AA requires certain assessees to compulsorily maintain the prescribed books of account. This section provides that every person carrying on legal, medical, engineering, or architectural profession or the profession of accountancy or technical consultancy or interior decoration or authorised representative or film artist shall keep and maintain the prescribed books of account and other documents in the following cases:

– if the gross receipts have exceeded Rs.1,50,000 in all the 3 years immediately preceding the previous year; or

– if, where the profession has been newly set up in the previous year, his gross receipts are likely to exceed Rs.1,50,000 in that year.

12.26 Income Tax

The following books of account and other documents are required to be maintained by the above-mentioned assessees (notified under Rule 6F) -

(i) a cash book;

(ii) a journal, if accounts are maintained on mercantile basis ;

(iii) a ledger;

(iv) carbon copies of bills and receipts issued, whether machine numbered or otherwise serially numbered, in relation to sums exceeding Rs.25;

(v) original bills and receipts issued in respect of expenditure exceeding Rs.50.

A person carrying on medical profession will be required to maintain the following in addition to the list given above:

(i) a daily case register in Form 3C.

(ii) an inventory under broad heads of the stock of drugs, medicines and other consumable accessories, as on the first and last day of the previous year, used for his profession.

It is significant to note that such professionals (whose professions are notified under Rule 6F) whose gross receipts are less than the specified limits given above are also required to maintain books of account but these have not been prescribed in the Rule. In other words, they are required to maintain such books of account and other documents as may enable the Assessing Officer to compute the total income in accordance with the provisions of this Act. Further, every person carrying on business or profession other than the professions notified under Rule 6F, must statutorily maintain such books of accounts and other documents as may enable the Assessing Officer to compute his total income in accordance with the provisions of the Income-tax Act, in the following cases -

(a) in cases where the income from the business or profession has exceeded Rs.1,20,000 or the total sales, turnover or gross receipts, as the case may be, in the business or profession has exceeded Rs.10,00,000 in any of the three years immediately preceding the accounting year;

(b) in cases where the business or profession is newly set up in any previous year, if the income from business or profession is likely to exceed Rs.1,20,000 or his total sales, turnover or gross receipts, as the case may be, in the business or profession are likely to exceed Rs.10,00,000 during the previous year;

(c) in cases where profits and gains from the business are calculated on a presumptive basis under section 44AD or 44AE or 44AF or 44BB or 44BBB and the assessee has claimed that his income is lower than the income prescribed in those provisions during the previous year;

(d) *in cases where the profits and gains from the business are deemed to be the profits and gains of the assessee under section 44AD and he has claimed such income to be lower than the profits and gains so deemed to be the profits and gains of his business and his income exceeds the basic exemption limit during such previous year (This would be effective from A.Y.2011-12).*

The CBDT has been authorised, having due regard to the nature of the business or profession carried on by any class of persons, to prescribe by rules, the books of account and other documents including inventories, wherever necessary, to be kept and maintained by the taxpayer, the particulars to be contained therein and the form and manner in which and the place at which they must be kept and maintained. Further, the CBDT has also been empowered to prescribe, by rules, the period for which the books of account and other documents are required to be kept and maintained by the taxpayer.

12.7 RELEVANCE OF PROFIT AND LOSS ACCOUNT PREPARED IN ACCORDANCE WITH THE PROVISIONS OF PARTS II AND III OF SCHEDULE VI TO THE COMPANIES ACT, 1956 FOR COMPUTING BOOK PROFITS FOR LEVY OF MAT [SECTION 115JB]

In the case of corporate assessees, if the income-tax payable on the total income as computed under the Income-tax Act, is less than *15%* of its book profit, such book profit shall be deemed to be the total income of the assessee and the tax payable by the assessee on such total income (book profit) shall be the amount of income-tax at the rate of *15%*. For the purpose of computation of book profits, every company is required to prepare its profit and loss account for the relevant previous year in accordance with the provisions of Parts II and III of Schedule VI to the Companies Act, 1956. The profit and loss account prepared for section 115JB(2) and annual accounts including profit and loss account prepared and placed before the Annual General Meeting should be based on the same accounting policies and accounting standards. Further, the method and rates for calculating the depreciation should also be the same. This requirement is applicable even if the company adopts a financial year which is different from the previous year under the Income-tax Act. The net profit as per the profit and loss account would be increased/decreased by the amounts as provided for in the *Explanation* to section 115JB to arrive at the book profit for levy of MAT.

12.8 CONCLUSION

Having studied the extent of recognition of accounting principles and standards by judicial forums while settling tax disputes and also the similarities and differences in the accounting treatment as per the Accounting Standards and income-tax law, it is now possible to answer the question raised in the beginning of this Chapter i.e. Are accounting principles and accounting standards recognized under taxation laws? As pointed out in the beginning, we can now see that the answer may be yes or no depending on the particular issue in respect of which the question is raised. The treatment of income-tax expense under the Accounting

12.28 Income Tax

Standards, particularly AS-22, which illustrates the treatment of differences between accounting income and taxable income, has also been explained in some length in this chapter. This chapter also gives a bird's eye view of the relevance of the method of accounting and the significance of Inclusive and Exclusive method of accounting of tax, duty etc. while valuing stock. Finally, the requirement of compulsory maintenance of books of account under the income-tax law and the relevance of profit and loss account prepared under the Companies Act for levy of MAT has also been explained to help in further understanding of the inter-relationship between accounting and taxation.

Self-examination questions

1. Explain whether accounting principles are recognized by judicial forums while settling tax disputes, with the aid of case laws.
2. Explain the areas of similarity in treatment of expenses/income/assets/liabilities under Accounting Standards and Income-tax law.
3. Mention the areas where there is a difference in treatment of expenses/income/ assets/liabilities under the Accounting Standards and Income-tax law.
4. Distinguish between "Permanent difference" and "Timing difference", with the help of examples.
5. When does a deferred tax asset and deferred tax liability arise? Explain giving examples.
6. What are the criteria for recognizing a deferred tax asset?
7. What are the accounting entries to be passed for recognition and reversal of a deferred tax asset and deferred tax liability?
8. What are the steps involved in measuring income-tax expense for the purpose of interim financial reports?
9. Explain the significance of the method of accounting under Income-tax law.
10. Explain the method of accounting of tax, duty etc. under section 145A of the Income-tax Act and Accounting Standard 2 on valuation of inventories.

13

ASSESSMENT OF VARIOUS ENTITIES

13.1 ASSESSMENT OF INDIVIDUALS

The term "individual" as such has nowhere been defined in the Income-tax Act. Section 2(31), however, states that "person" *inter alia*, includes an individual. In the commonly understood sense of the term, an individual means a human being or a single person. The person may be major, minor, married or unmarried, possessing sound or unsound mind. All the same, he is assessable as an 'individual' and is liable to pay tax, if the total income earned by him during any previous year exceeds the prescribed limit exempted from tax. If an individual who is liable to pay tax for any year dies before he is assessed to tax, his executor, administrator or legal representative is treated as the individual assessee for purposes of assessment of the income of the deceased person. In the c ase of an individual who is a minor or a lunatic, the assessment of his income will be made on his guardian or the trustee. However, if the incapacitated person has no trustee or guardian or trustee or guardian is a non-resident and cannot be traced, the assessment can be made directly on the minor or lunatic. The rights and duties of all representative assessees are the same as those of the persons they are representing.

13.1.1 Total income of an individual: The total income of an individual for any previous year, which is liable to tax, is to be computed under the various heads discussed earlier. Further, sections 60 to 65 of the Income-tax Act provide for clubbing of income arising to minor children, spouse, daughter-in-law etc. with the income of the individual under certain circumstances. These provisions must be strictly construed inasmuch as they create an artificial liability to tax. (Students may refer to the discussion of this topic contained in Chapter 9 for a detailed study of these provisions).

A married woman, being an individual, is liable to income tax in respect of the total income of any previous year arising to her in her own right, including the income from assets inherited by her or gifted to her by a person other than her husband or her father-in-law or mother-in-law.

13.1.2 Assessment of a non-resident individual : The tax structure explained above is also applicable to an individual who is a non-resident during the previous year. The scope of income taxable in the hands of a non-resident as laid down in section 5 has already been explained in section 9(1) of the Act which extends the liability to tax of a non-resident individual in respect of income which although not actually accruing or arising in Indians deemed to be so accruing or arising, assumes significance in the assessment of non-resident individual. For a detailed consideration of the provisions of section 9, students are advised to refer to Chapter 2.

13.1.3 Flat rate of tax on winnings from lotteries, crossword puzzles etc. [Section 115BB] : Under section 115BB, gross winnings from lotteries, crossword puzzles, races including horse races (other than income from the activity of owning and maintaining race horses), card games and other games of any sort or from gambling or betting of any nature whatsoever shall be chargeable to income-tax at a flat rate of 30% on the gross winnings.

13.1.4 Tax on non-resident sportsmen or sports associations [Section 115BBA] : This section is applicable where the total income of an assessee,

(a) being a sportsman (including an athlete), who is not a citizen of India and is a non-resident, includes any income received or receivable by way of participation in any game or sport or advertisement or contribution of articles in relation to any game or sport in India in newspapers, magazines, journals

(b) being a non-resident sports association or institution, includes any amount guaranteed to be paid or payable to such association or institution in relation to any game or sport played in India.

The income-tax payable shall be the aggregate of -

(i) the amount of income-tax calculated on the income referred to in clause (a) or clause (b) at the rate of 10%; and

(ii) the amount of income-tax with which the assessee would have been chargeable had the total income of the assessee been reduced by the amount of income in clause (a) and (b).

No deduction in respect of any expenditure or allowance shall be allowed under any provision of this Act in computing the income referred to in clause (a) or clause (b).

13.1.5 Special provisions relating to certain incomes of non-residents - Chapter XII A: This Chapter seeks to lay down a concessional method of taxation of certain specified income of non-residents. For this purpose, a non-resident Indian means a non-resident individual who may either be an Indian citizen or a person of Indian origin. A person shall be deemed to be Indian origin if he or either of his parents or any of his grand-parents was born in undivided India.

'Foreign exchange asset' means any 'specified asset' which the assessee has acquired, purchased with or subscribed to in convertible foreign exchange. Such 'specified assets' are as follows:

(a) shares in an Indian company.

(b) debentures issued by an Indian company which is not a private company as defined in the Companies Act, 1956.

(c) deposits with a non-private Indian company.

(d) any specified securities of Central Government.

(e) units of the Unit Trust of India.

(f) such other assets as may be notified by the Central Government.

The income derived from such a foreign exchange asset is called investment income.

"Investment income" means any income derived (other than dividends referred to in section 115-O) from a foreign exchange asset.

"Long-term capital gains" means income chargeable under the head "Capital Gains" relating to a capital asset, being a foreign exchange asset which is not a short-term capital asset.

13.1.6 Flat rate for investment income and long-term capital gains [Section 115E]: Where the total income of a non-resident Indian consists only of investment income and capital gains arising out of the transfer of long-term foreign exchange assets, tax payable by him shall be the aggregate of :

(i) income-tax on investment income at the rate of 20%;

(ii) income-tax on long-term capital gains at the rate of 10%; and

(iii) income-tax on his other total income.

13.1.7 Exemption on capital gains arising from transfer of long-term foreign exchange asset [Section 115F]: Where the non-resident Indian transfers the original foreign exchange asset and within a period of six months of such a transfer deposits or invests the whole or part of the net consideration in:

(a) any specified asset or

(b) any notified savings certificates referred to in section 10(4B)

then, the capital gains arising on such a transfer will be dealt with as follows :

If the cost of the new asset, referred to in (a) or (b) above, is not less than the net consideration in respect of the original asset the whole of such capital gain shall be exempt. If such cost is less than the net consideration, the exemption will be limited to:

13.4 Income Tax

$$\text{Total capital gain} \times \frac{\text{Cost of new asset}}{\text{Net Consideration}}$$

Note:

1. When the new asset consists of deposits, the cost means the amount of such deposits.
2. Net consideration means the full value of the consideration received or accruing as a result of the transfer as reduced by any expenditure incurred wholly and exclusively in connection with such transfer.
3. Where the new asset is transferred or converted (otherwise than by transfer) into money, within a period of three years from the date of its acquisition, the capital gain, exempted as above, shall be chargeable as long term capital gain of the previous year in which the new asset is transferred or converted.

13.1.8 Return need not be filed [Section 115G]: Where the total assessable income of the non-resident during the previous year consisted only of investment income and long-term capital gains relating to foreign exchange assets and tax on such income has been deducted at source then he need not file a return of income under section 139(1).

13.1.9 Benefits available even after the assessee becomes a resident [Section 115H]: Where a person, who is a non-resident Indian in any previous year, becomes assessable as resident in India in respect of the total income in any subsequent year, he may furnish a declaration along with such a return to the effect that the provisions of this chapter shall continue to apply to him in relation to the investment income derived from any foreign exchange asset being debentures, deposits, securities of Central Government and such other notified assets. If he does so, then these provisions will continue to apply to him till such assets are transferred or otherwise converted into money.

13.1.10 Option to the assessee [Section 115-I] : A non-resident Indian may elect not to be governed by these provisions. For this purpose he has to declare in the return regarding his option not to be governed by these provisions. In such a case the total income and tax payable there on will be computed in accordance with the other provisions of this Act and consequently, the provisions of this chapter will not apply to such non-resident assessees.

13.1.11 Special concessions in the case of individuals not being citizens of India: Although basically the law of income-tax is applicable alike to both citizens and non-citizens of India, and there is no difference in the general principles for computing the total income under the Income-tax Act, however, on a consideration of the peculiar circumstances in which a foreigner might come to or live in India, certain concessions and reliefs are granted to them. These have been discussed in detail in Chapter 3 under the head 'Incomes not includible in the total income' [Section 10(6)].

13.1.12 Exemptions and reliefs available to individuals : The tax exemptions and reliefs available under the Act to individuals in respect of income chargeable to tax fall under the following categories :

1. Income altogether excluded from the total income, and on which in consequence, no income-tax is payable[Section 10].
2. Deductions from gross total income both in respect of income, a part of which is not chargeable to income-tax and payments made by the assessee, a part or the whole of which is deductible from the gross total income.
3. Relief in tax when salary is paid in arrears [Section 89].
4. Special treatment for certain kinds of income [Section 180 and 180A].

13.1.13 Rebate of tax and relief in certain cases

- **Income from association of persons or bodies of individuals:** If the assessee is a member of an association of persons or a body of individuals (other than a H.U.F., a company or a firm) income-tax shall not be payable by him in respect of any portion of the amount receivable by him from the association or body on which tax has already been paid by the association or body [Section 86]. For the purposes of this provision in the case of an association of persons which is assessable under section 67A, the members of the AOP whose shares in the income are indeterminate or unknown, will be entitled to receive equal shares in the income of the AOP and the individual share of such member will be determined accordingly.
- **Relief when salary etc. is paid in arrears or in advance [Section 89]:** It has already been explained in the Chapter relating to salaries that arrears or advances of salaries are assessable in the hands of the recipients in the year in which these are received. Consequently, in a financial year, an employee may become chargeable to tax in respect of salary for more than 12 months. Likewise any payment in the nature of profit in lieu of salary (within the meaning of section 17(3) of the Act) is also chargeable in the year of receipt in addition to the normal salary received by the employee. In consequence, the aggregate salary income may become liable to tax at a rate higher than that at which it would otherwise have been assessed. To obviate such a hardship, the Assessing Officer has been empowered to grant relief in appropriate cases, on the employee making an application, in accordance with Rule 21A of the Income-tax Rules.

  In appropriate cases coming under section 192(2A), where the employer is the Government or a public sector undertaking, co-operative society, local authority, university, institution or body, such employer himself is entitled to take into account the relief under section 89(1).

13.6 Income Tax

13.2 ASSESSMENT OF HINDU UNDIVIDED FAMILIES

13.2.1 Concept of HUF

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

The relation of a HUF does not arise from a contract but arises from status. A Hindu is born into a HUF. A male member continues to remain a member of the family until there is a partition of the family. After the partition, he ceases to be a member of one family. However, he becomes a member of another smaller family. A female member ceases to be a member of the HUF in which she was born, when she gets married. Thereafter, she becomes a member of the HUF of her husband.

Some members of the HUF are called co-parceners. They are related to each other and to the head of the family. A HUF may contain many members, but members within four degrees including the head of the family (kartha) are called co-parceners. A hindu co-parcenary includes those persons who acquire by birth an interest in the joint coparcenary property. Only the coparceners have a right to partition.

13.2.2 Schools of Hindu Law

There are two schools of hindu law. They are –

(1) Mithakshara school of hindu law

(2) Dayabhaga school of hindu law

Mithakshara law is followed by entire India except West Bengal and Assam. There is a basic difference between the two schools of thought with regard to succession. Under the Mithakshara law, the inheritance is by birth. One acquires the right to the family property by his birth and not by succession irrespective of the fact that his elders are living. Thus every child born in the family acquires a right/share in the family property.

Dayabagha law prevails in West Bengal and Assam. In Dayabagha law, nobody acquires the right, share in the property by birth as long as the head of family is living, that is, the children do not acquire any right, share in the family property, as long as his father is alive and only on death of the father, the children will acquire right/share in the property. Thus, the father and his brothers would be the coparceners of the HUF

13.2.3 Assessment of Hindu Undivided family

The income of a HUF is to be assessed in the hands of the HUF and not in the hands of any of its members. This is because HUF is a separate and a distinct tax entity.

Partition of HUF – There are two types of partition. They are –

(1) **Total partition** – is a partition by which the entire family property is divided amongst the coparceners. After the total partition, the HUF ceases to exist as such.

(2) **Partial partition** – is a partition which is partial as regards either the persons constituting the joint family or as regards the properties belonging to the joint family or both. In case of a partial partition as regards persons constituting the joint family, some coparceners may separate from the joint family while the others might continue to remain as part of the joint family. In case of a partial partition as regards the property, there may be a division or severance of interest in respect of some part of the estate of the joint family, while the rest of the estate may continue to remain as property of the joint family.

Effect of partial partitions made after 31st December, 1978

However, partial partitions after 31st December, 1978 are not recognized for tax purposes. If any partial partition has been effected after 31.12.78, then no claim of such partial partition shall be recorded by the Assessing Officer. Such family will continue to be assessed as if no such partial partition has been effected. Every member of the HUF, immediately before such partial partition, and the HUF shall be jointly and severally liable for any sum payable under the act. The several liability of a member would be proportionate to the share of joint family property allotted to him on such partial partition.

Assessment after total partition

When a claim of total partition of HUF has been made by any member of the HUF on behalf of the HUF, the Assessing Officer shall inquire into such claim. For this purpose, he shall give notice to all the members of the HUF. Thereafter, the Assessing Officer shall, on completion of inquiry, record a finding as to whether total partition has taken place and if so, the date when such partition was effected. If partition has been effected in the previous year, the total income of the HUF for the previous year up to the date of partition shall be assessed as income of the HUF. Every member of the HUF is jointly and severally liable for payment of tax on such assessed income of the HUF. The several liability of a member would be proportionate to the share of joint family property allotted to him on such partition.

13.8 Income Tax

13.2.4 Computation of total income of HUF

The following points should be taken into consideration while determining the total income of HUF -

(1) Income from the transfer of a self acquired property by an individual to his HUF for inadequate consideration or conversion of the self-acquired property into property of the HUF is not considered as the income of the HUF. It would be included in the income of the individual member who transferred the property to the HUF [section 64(2)]

(2) Income from an impartible estate is included in the hands of the holder of the estate and not in the hands of the HUF. Even if the impartible estate is owned by the HUF, income from such estate is includible in the hands of the holder of the estate who is the eldest member of the HUF.

(3) Section 10(2) exempts any receipt by an individual as a member of a HUF out of the family income or out of the income of the impartible estate belonging to the family.

(4) If a member of the HUF receives any fee or remuneration as a director or a partner in a company or firm as a consequence of the investment made in such concern out of the funds of the HUF, such fee/remuneration shall constitute income of the HUF. However, any such fee or remuneration earned by a member of a HUF as a director or partner for services rendered purely in his personal capacity, will be included in the income of the individual member and not the HUF.

Income received in the capacity as a member: Section 10(2) gives total exemption in respect of any sum received by an individual as member of a Hindu Undivided Family either out of income of the family or out of any impartible estate belonging to the family.

Conversion of separate property into property of HUF: However, to the above exemption there is an exception provided by section 64(2). Even though we have discussed this in the appropriate place it will be better to recapitulate.

Before this, let us understand the concept of conversion. Generally income from self-acquired property of an individual, who is a member of a HUF will be assessed as his personal income and not as the income of the family. However, the individual can convert his separate properties into the property of the HUF. There are no legal formalities to be complied with. These principles have been upheld by various judicial rulings.

It naturally follows that once the assets belonging to the individual are impressed with the character of joint family property, the income arising therefrom, should be assessed as the income of the HUF. However, the deeming provisions of section 64(2) specifically provide that the entire income from the converted property is taxable as the income of the transferor. This provision applies not only to property converted in the above manner but also covers transfer of property by an individual, directly or indirectly, to the family otherwise than for adequate consideration, in other words, gifts. Accordingly, where an

individual makes direct or indirect gift of his separate property to the Hindu Undivided family of which he is a member or what he transfers his separate property to his family for less than its fair market value, the provision of section 64(2) will be attracted and the entire income from such separate property converted into HUF property will be included in the total income of the individual.

Example: A converts his self-acquired property into HUF property consisting of Mr.A, Mrs. A, B (A's major son) and C (A's minor son) on 1-4-08. The annual income from such property is Rs.12,00,000. On 1-4-09, a partition took place among the members of the family and above converted property was divided amongst the members according to Hindu Law provisions. A has got income from other sources to the extent of Rs.1,00,000. The HUF's income from other sources amounted to Rs.80,000. Find out the taxable income of Mr.A and HUF for the assessment years 2009-10 and 2010-11.

Assessment of Mr.A

Assessment year 2009-10: As per the provisions of section 64(2)(b), the entire income derived from the converted property will be deemed to arise to A and not to family. Hence it will be included in A's individual assessment.

	Rs.
Income from converted property	12,00,000
Income from other sources	1,00,000
Total	13,00,000

Assessment year 2010-11 subsequent to partition: Section 64(2)(c) provides that on such partition, the income derived from such converted property as is received by the spouse or minor child on partition shall be deemed to arise to the spouse or minor child from assets transferred indirectly by the individual to the spouse or minor child. Hence, the income received by the spouse or minor child from such converted property shall be deemed to be the income of the transferor.

	Rs.	Rs.
Thus, out of Rs.12,00,000,		
A's share is 1/4th		3,00,000
Mrs. A's share 1/4th	3,00,000	
C (minor son's share 1/4th)	3,00,000	6,00,000
		9,00,000
Income from other sources		1,00,000
		10,00,000

Assessment of HUF:

Assessment year 2009-10: The proviso to section 64(2) says that once income from property has been included in the total income of the individual, it will be excluded from

the total income of the family. Therefore, Rs.12,00,000 having already been included in A's individual assessment will not be again assessed in the family's assessment.

	Rs.
Other income	80,000
	80,000

Assessment year 2010-11: As per the provisions of section 64(2)(c) the income derived by A, his spouse and his minor child have already been included in A's individual assessment. The share of B, A's major son, will be assessed in B's individual assessment. Hence, only other income is to be included in the family's assessment

	Rs.
Other income	80,000
	80,000

Can a female member throw personal property into joint family hotchpot? A connected question here is that whether a female member can impress upon her personal property the character of joint family property. The right to blend is limited to coparceners and a female member of the joint family cannot blend her separate property (even if she is an absolute owner thereof) with the joint family property. To blend is to share along with others and not to surrender one's interest in favour of others to the exclusion of oneself. A Hindu female cannot therefore "blend" because she, not being a coparcener, has no right to demand a share in the joint family property by asking for a partition. But she can always gift her absolute property to the family and then the property belongs to the family and the income arising out of the assets is to be taxed in the hands of the family. These principles emerge in the Supreme Court's decision in *Puspha Devi Vs. CIT (1977) 109 ITR 730.*

13.2.5 Business in the personal capacity of the Karta or member : Where the Karta or any member of a joint family carries on a business on his personal account, the income from any such business would constitute his personal income. It does not matter even if the business of the member and of the joint family are identical in nature and size. Now one important question arises. Suppose the capital for the individual's business is borrowed from the funds of the family what will be the position? Consider the following example.

Example 1: A HUF consists of the Karta, his wife, two sons and daughter. The HUF runs a departmental store. One of the two sons is qualified in business administration and the other one is an automobile engineer. Together they start a garage for repairing all types of motor cars. The technical aspects are looked after by the engineer while the general administration is taken care of by the son qualified in business administration. For starting the business the HUF has advanced an interest-free loan of Rs.50,000. The business is

yielding good profits. Now the question arises whether the income from the business should be assessed in the hands of the Hindu undivided family.

Answer: It is obvious that the family, in providing the interest-free loan to the business of the brothers has suffered a detriment. However, the Delhi High Court has laid down the following proposition in this connection in the case of *CIT vs. Charan dass Khanna & Sons (1980) 123 ITR 194 (Delhi)*. If investment plays a minor role and it is primarily the personal efforts, specialised skill and enterprise of the individual coparceners which resulted in the new business being set up and the profits accruing, it may not essentially be said that the income belongs to the HUF. In the given example the good profits are more due to the specialised skills acquired by the two sons in their respective fields. Of course, the capital, got from the family as interest free loan, has its role to play but it is nevertheless a minor one. Therefore, we can say that the income from the business set up by the brothers is assessable in their hands as individuals according to the agreed rate of sharing and not as the income of the family.

The Supreme Court has also upheld this principle in *K.S. Subbiah Pillai vs. CIT (237 ITR 11).* It was held that remuneration received on account of personal qualification and exercise of individual exertion was assessable as individual income and not as income of HUF. The following principles have been broadly applied by the Supreme Court for determining the character of the receipt by way of remuneration paid to a coparcener:

(i) when the remuneration received by the coparcener though not in form but in substance was one of the modes of return made to the family because of investment of the family funds, it has to be assessed as the income of Joint Hindu Family.

(ii) when the remuneration is not paid to the detriment of the family funds, it is assessable as the income of recipient Karta or coporcener as an individual.

(iii) when it is a compensation for the services, skill or labour of the coparcener, it has to be assessed as the income of such a coparcener in his individual capacity.

Example 2: The Karta of a HUF receives salary in his capacity as a treasurer and secretary of a bank. The HUF has furnished Rs.1,00,000 as security deposit. Decide whether the salary can be assessed as the income of the HUF.

Answer: The position of treasurer and secretary requires considerable personal skill and integrity on the part the incumbent. It is true that the security deposit might have been furnished by the HUF, however, since the salary is paid to the Karta primarily for the exercise of his personal skill and integrity, it is to be assessed as his individual income.

Hence, students should carefully understand the following:

(a) Where the funds of a HUF are invested in a company or a partnership firm, the dividends or share of profits are generally taxable as the income of the family. In such a case the fee, salary, commission or other remuneration received by the Karta,

or any member of the family, in his capacity as director or partner would also be taxable as income of the family. The reasons for this treatment are as follows:

(1) The income is earned by the detriment to the joint family funds.

(2) It is earned with the aid of joint family funds.

(3) There is real and sufficient connection between the investment or the joint family funds and the income of remuneration earned.

(b) However, where the income is earned by the karta or any other member of the family by the exercise of the personal skill the income should be assessed in their individual hands even if some detriment is caused to the family funds, say, by way of loan, guarantee etc. whose role is only secondary.

13.2.6 Members of HUF and Partnership firms : A Hindu undivided family can become a partner in a firm. However, since it has no separate legal entity of its own, its Karta alone can be partner in the firm representing the family. The coparcenery has no place in the partnership.

When the Karta of joint Hindu family enters into a partnership with strangers, the member of the family do not *ipso facto* become partners in that firm. They have no right to take part in its management or to sue for its dissolution. The creditors of the firm are entitled to proceed against the joint family assets including the shares of the non-partner coparceners for their debts. This is because under Hindu Law, the Karta has the right when carrying on business to pledge the credit of the joint family to the extent of its assets. The liability on the part of other members of the HUF arises by reason of their status as coparceners and not by reason of any contract of partnership by them.

Partnership between Karta representing family and Coparcener: A Karta of a HUF representing the family on the one hand, and a member of that family in his individual capacity on the other, can enter into a valid partnership. An individual coparcener, while remaining joint, can possess, enjoy and utilise in any way he likes, property which is his individual property. Therefore, when he enters into partnership with the family he retains his share and interest in the property of the family while he simultaneously enjoys the benefit of his separate property and fruits of its investment.

13.2.7 Salary paid to Karta for managing the family's business: If remuneration is paid to the Karta of Hindu undivided family under a valid agreement which is bona fide and in the interest of and expedient for the business of the family and the payment is genuine and not excessive, such remuneration would be an expenditure laid out wholly and exclusively for the purpose of the business of the family and would be allowable as an expenditure.

13.2.8 Salary paid to member: A Hindu undivided family can be allowed to deduct salaries paid to member of the family if the payment is made as a matter of commercial or business expediency, but the service rendered must be to the family.

13.2.9 Gifts by HUF: A HUF as such is incapable of making a gift to any of its member. However the Karta of a HUF has power to gift out of joint family property for certain approved purposes. The gift should be reasonable. For example, a father may make a gift of the ancestral moveable properties of the joint family, of which he is the Karta, for the purpose of discharging duties prescribed by Hindu Law. The income of the joint family will stand reduced to the extent to the income arising out of the assets thus gifted out.

13.2.10 Gifts to HUF: Can an outsider make a gift to HUF? Under what circumstances will a gift made by an outsider be considered as a gift to the HUF? The answers to these questions are as follows:

(a) If the HUF to which such a gift is made consists of only one coparcener, then the gifted property can be held by the members of the family only as tenants-in-common, i.e., the income arising out of such gifted property can be assessed as income in the hands of the Association of Persons (AOP).

(b) If the HUF to which such a gift is made consists of minimum two coparceners, then the gifted property can be held by the members of the family as joint tenants and the income arising out of such gifted property can be assessed as income in the hands of the joint Hindu family.

Section 56(2)(vi) provides that any sum of money received by a HUF from non-relatives on or after 1.4.2006 but before 1.10.2009 would be chargeable to income-tax under the head "Income from other sources", if the aggregate value of such gifts exceed Rs.50,000 during a year. *Further, new clause (vii) has been inserted in section 56(2) w.e.f. 1.10.2009 to bring within its scope, in addition to any sum of money, the value of any property received without consideration or for inadequate consideration.* For details refer Chapter 8 on "Income from other sources".

13.2.11 Nature of property inherited by a Hindu under section 8 of Hindu Succession Act: There was a judicial controversy regarding the issue as to whether the property which devolved on a Hindu, on the death of his father intestate, after the coming into force of the Hindu Succession Act, under section 8 of that Act, would constitute HUF property consisting of his own branch including his sons in his individual property. The High Courts of Allahabad, Madras (Full Bench), M.P. and A.P. on the one side, held the view that such property would be individual property in the hands of the son while the Gujarat High Court on the other hand took the view that such property would be in the nature of joint family property in the hands of the son and not his separate property.

The Supreme Court has resolved this controversy in the case of *C.W.T. v. Chander Sen (1986) 58 CTR (SC) 119* by overruling the Gujarat High Court's decision and approving the view of the other courts. The Supreme Court pointed out that the Hindu Succession Act was enacted to amend and codify the law relating to intestate succession among Hindus. Section 8 of this Act lays down the scheme of devolution of the property of a

Hindu dying intestate and the express words of this provision cannot be ignored and must prevail.

Certain heirs have been classified in the Schedule under section 8 whom such property should develop. Those specified in class I take the property simultaneously to exclusion of all the other heirs. Class I heirs include son, daughter, etc. including the son of a predeceased son but does not include specifically the grand son being a son of a living son. The Supreme Court emphasized that the grandson could not get any right in the property of his grandfather. In this view of the matter, the Supreme Court held that when the son inherits the property in the situation contemplated by section 8 he does not take it as Karta of own undivided family.

The property which devolved on a Hindu on the death of his father intestate after the coming into force of the Hindu Succession Act, 1956 did not constitute HUF property consisting of his own branch including his sons.

In the case before the Supreme Court, R and his son C constituted a HUF. On 10.10.1961 there was a partial partition in the family by which the business was divided between the father and the son and thereafter it was carried on by a partnership consisting of the two. On 17.7.1965, R died leaving behind his son C and his grandsons i.e. the sons of C. His wife and mother predeceased him and he had no other issue except C. On his death there was a credit balance of Rs.1,85,043 in his account in the books of the firm. For the assessment year 1966-67 the sum of Rs.1,85,043 standing to the credit of R was not included in the net wealth of the family of C (the assessee family) on the ground that this amount devolved on C in his individual capacity and was not the property of the assessee family. A sum of Rs.23,330 was credited to the accounts of late R on account of interest accruing on his credit balance. In the proceedings under Income-tax Act for the assessment year 1967-68, the sum of Rs.23,330 was claimed as deduction.

The Assessing Officer disallowed the claim relating to interest on the ground that it was payment made by C to himself. Likewise,in the wealth-tax assessment, the amount standing to the credit of R was included by the Assessing Officer in the wealth of the assessee's family.

The Supreme Court based on the reasoning explained earlier, held on the facts of the case, that the sums standing to the credit of R belonged to C in his individual capacity and not the Hindu family and the interest of Rs.23,330 was an allowable deduction in respect of the income of the family from the business *(CWT Vs. Chander Sen (1986) 58 CTR 119 (SC))*.

13.3 ASSESSMENT OF LOCAL AUTHORITY

13.3.1 General meaning: The expression "local authority" has been defined not by the Income-tax Act but by section 2(31) of the General Clauses Act. A local authority is a person under section 2(31) of the Income-tax Act and thus constitutes a separate unit of

assessment. It is chargeable to tax on its total income in respect of the previous year, computed in accordance with and under the basic provisions of the Act, which apply to other taxable entities and for all purposes of the Act, this entity is included in the term 'person'. All municipal corporations, or councils, committees, panchayat boards, port trusts, district boards and other authorities legally entitled to or entrusted by the Central or State Government with the control and/or management of a municipal or local fund are covered by the expression 'local authority'.

13.3.2 Exemptions: Under section 10(20), the income of a local authority which is chargeable to tax under the heads 'Income from house property,' 'Capital gains' and 'Income from other sources' accruing or arising to it anywhere in or outside India and income from a trade or business carried on by it which accrues or arises to it from the supply of a commodity or service with its own jurisdiction or from the supply of water or electricity within or outside its own jurisdictional area are totally exempt from tax. In other words, a local authority is taxable only in respect of the income arising to it from any business carried on by it provided that such income arises from the supply of any commodity or service, not being water or electricity outside its jurisdictional area, i.e., territorial limits.

A local authority is said to be resident at the place where the control and management of its affairs are situated and its residential status is governed by section 6(4). A local authority in India is always resident in India, except where the control and management of its affairs is exercised wholly from outside India.

13.3.3 Tax rate : After total income, i.e., the income of a local authority chargeable to tax has been determined, the whole of it would attract tax at the rate applicable i.e., the one prescribed by the relevant Finance Act. There is no minimum amount exempt from tax in the case of a local authority: for income tax purposes, local authority is chargeable to tax on the whole of its income at 30%.

13.4 ASSESSMENT OF FIRMS/LLPS AND THEIR PARTNERS

A firm is to be assessed as a unit and the share income from the firm in the hands of the partners is exempt. There is no need for registration.

13.4.1 General : Under section 2(23) of the Income-tax Act, the terms 'firm', 'partner' and 'partnership' have the same meanings respectively as have been assigned to them under the Indian Partnership Act, 1932, but the expression 'partner' also includes any other person who being a minor, has been admitted lo the benefits of an existing partnership. A firm though not a legal person or juridical entity, is chargeable to tax as a separate entity distant from the partners and the partners are assessable as individuals and not as an association persons or body of individuals. The term 'firm' as used in the Act covers both registered and unregistered firms.

13.16 Income Tax

Note - Consequent to the Limited Liability Partnership Act, 2008 coming into effect in 2009 and notification of the Limited Liability Partnership Rules w.e.f. 1st April, 2009, the Finance (No.2) Act, 2009 has incorporated the taxation scheme of LLPs in the Income-tax Act on the same lines as applicable for general partnerships, i.e. tax liability would be attracted in the hands of the LLP and tax exemption would be available to the partners. Therefore, the same tax treatment would be applicable for both general partnerships and LLPs.

Consequently, the following definitions in section 2(23) have been amended -

(1) The definition of 'partner' to include within its meaning, a partner of a limited liability partnership;

(2) The definition of 'firm' to include within its meaning, a limited liability partnership; and

(3) The definition of 'partnership' to include within its meaning, a limited liability partnership.

The definition of these terms under the Income-tax Act would, in effect, also include the terms as they have been defined in the Limited Liability Partnership Act, 2008. Section 2(q) of the LLP Act, 2008 defines a 'partner' as any person who becomes a partner in the LLP in accordance with the LLP agreement. An LLP agreement has been defined under section 2(o) to mean any written agreement between the partners of the LLP or between the LLP and its partners which determines the mutual rights and duties of the partners and their rights and duties in relation to the LLP.

The residential status of a firm to be determined depending upon the fact whether or not the control and management of its affairs is exercised from within India. Even if the negligible part of the control and management is exercised from within India the firm would be resident in India for all the purposes. For determining the residential status of a firm, it is immaterial to ascertain the residential status of partners thereof because a firm may be resident even in cases where all the partners are not resident in India and they control or manage the affairs from outside India. Every firm is liable to pay tax flat rate of 30% on its total income of the previous year computed in accordance with the provisions of the Act, plus education cess@2% plus secondary and higher education cess@ 1%.

The following are the salient features of assessment of partnership firms:

(i) The firm will be taxed as a separate entity. There will be no distinction between registered and unregistered firm.

(ii) The share of the partner in the income of the firm will not be included in the hands of the partner. It will be exempt under section 10(2A).

(iii) Any salary, bonus commission or remuneration, by whatever name called, which is due to or received by a partner will be allowed as a deduction subject to certain restrictions.

(iv) Where a firm pays interest to any partner the firm can claim deduction of such interest from its total income. However, the maximum rate at which interest can be

allowed to a partner will be 12% per annum.

(v) The income of the firm will be taxed at a flat rate of 30%. Education cess @ 2% and secondary and higher education cess@1% will be levied on income tax.

For the purpose of our discussion we can divide the partnership firms assessable under this Act into two types.

(a) Partnership firms assessed as such (PFAS)

(b) Partnership firms assessed as association of persons (PFAOP)

13.4.2 Partnership Firm Assessed As Such (PFAS) [Section 184]

Conditions to be fulfilled: To get the status of PFAS the firm should be evidenced by an "Instrument". The word "instrument" means a document of legal nature by which any right or liability is created, limited, extended, or extinguished.

Instrument does not necessarily mean a regular partnership deed, but it may constitute any other relevant document. If the terms of a partnership are contained in a number of documents or in the correspondence between the parties, the documents or letters would constitute "instrument" for the purposes of section 184(1)(i).

The next condition is that the individual shares of partners must be specified in the instrument. A firm cannot get the status of PFAS unless the instrument of partnership specifies the individual shares of partners in the profits of the partnership. Evidence regarding the shares of partners should be available within the framework of the instrument. It should not involve searching of a number of documents.

The next condition is that a certified copy of the instrument should accompany the first return of income of a firm. As already noted "instrument" in this sense refers not only to the partnership deed but also other documents from which the existence of partnership can be proved. Accordingly, certified copies of all documents will have to be submitted. Section 184 requires that the copy of the instrument shall be certified in writing by all partners other than minors. If, however, the return is made after the dissolution of the firm, it should be certified by all partners other than minors who were partners in the firm immediately before dissolution and by the legal representative of any such partner who is deceased. The certified copy of the instrument of partnership shall accompany the return of income of the firm of the previous year relevant to the assessment year.

If there is any change in the constitution of the firm or profit-sharing ratio during any previous year, a certified copy of the revised instrument of partnership should be filed along with the return of income of the relevant assessment year. Even if there is a change in remuneration/payment of interest to partners but there is no change in profit sharing ratio, a copy of the revised instrument of partnership should be submitted along with return to comply with the provisions of section 40(b).

13.18 Income Tax

Section 184(5) provides that where the firm commits any default as mentioned in section 144 the firm shall be assessed as a firm and not as an AOP, which was the case earlier. However, no deduction for payment of interest, salary, bonus, commission or remuneration, by whatever name called, made by the firm to any partner shall be allowed in computing the income chargeable under the head "Profits and gains of business or profession". However, the interest, salary, bonus, commission or remuneration so disallowed shall not be charged to tax in the hands of the partners under clause (v) of section 28.

Computation of income of partnership firm: While computing the income of a firm assessed as such, we have to keep in mind the following points:

(1) Remuneration is to be allowed

(2) Interest is to be allowed

(3) Unabsorbed depreciation and other losses should be provided for.

Remuneration paid to partners: First let us discuss the question of deduction of remuneration to the partners. In this context we have to remember the conditions prescribed by section 37 as regards the allowability of residuary expenses. Accordingly, no capital expenditure or personal expenses will be allowed. Further the remuneration paid must be only and exclusively for the purposes of the business of the firm. Apart from the general conditions prescribed in section 37 there are certain specific conditions prescribed by section 40(b).

They are as follows: -

(1) Such remuneration should be paid only to the working partner

(2) It should be authorised by the partnership deed

(3) It should not pertain to a period prior to partnership deed

(4) It should not exceed the permissible limit.

(1) **Payment should be to a working partner:** Explanation to section 40(b) defines working partner as one who is actively engaged in conducting the affairs of the business or profession of the firm of which he is a partner. This definition is very general. It seems that a partner can be a working partner in more than one firm. If a partner is employed somewhere else too, he can still be a working partner in the firm. However, in all such situations the partner must infact be a working partner in the firm. In other words, merely because a person is working somewhere else too, such a fact does not by itself debar him from being a working partner in a firm in which he is a partner. As stated before, to be a working partner, the partner has to be actively engaged in conducting the affairs of the business or profession of the firm. Now in order to be actively engaged in conducting the affairs of the business or profession

does not require either expressly or by implication that the concerned partner should be so actively engaged in conducting the business affairs on a full time basis. A partner can be said to be actively engaged in conducting the affairs of the firm even if he devotes a part and not the whole of his working hours.

Further, in order to be actively engaged in the affairs, a partner is not expected to be engaged in the whole of the affairs of the business of the firm, nor is he expected to know everything about the affairs of the business of the firm. For example, in a firm with many partners one partner may be looking after purchases, another after sales and another after production and still another after administration, finance and accounts. It cannot be contended that just because they are not over all incharge, they cannot be considered as working partner. Another significant point to be noted here is that the definition of "working partner" in Explanation 4 contemplates an individual. Therefore a partner other than an individual (example a company) cannot be working partner. An interesting situation may be considered here. When a company is a partner in a firm, a director or shareholder of the company can very well be an employee of the firm in which the company is a partner. Any salary/remuneration paid by the firm to such an employee would be totally outside the ambit of disallowance under section 40(b). This would be so because the individual who is an employee of the firm is not a partner in the firm. It is the company in which he is the director which is the partner and, section 40(b) contemplates allowance of remuneration paid by a firm to its partners and not to other employees.

(2) **It should be authorised by the Partnership Deed:** Any payment of salary, bonus, commission or remuneration by whatever name called to a working partner is not allowed as a deduction if the payment is not authorised by partnership deed or it is not in accordance with the terms of partnership deed. As a result, a mere general authority in the partnership deed that such and such working partners would be paid remuneration as may be agreed upon between the partners from time to lime will not be sufficient. The partnership deed will have to contain clear direction as to the quantum of remuneration to be paid to the working partners. For example such remuneration may be specified by way of annual fixed payment or as a certain specified percentage of the firm's book profit at the year end. It may be noted that such remuneration need not be paid on a monthly basis. An item like commission can be paid even as a percentage of sales. Remuneration also can be an yearly payment.

Now, a question arises whether the names of individual working partners should be specified in the partnership deed or whether it is sufficient if the total remuneration payable to the working partners as a whole is indicated. One opinion is that it is not necessary that the individual partners should be identified or designated. It will be sufficient to lay down an authorisation in the deed to the effect that remuneration will

be payable to the class of working partners up to so and so percentage of the book profit. And further that, within such limits the working partners shall share such remuneration in any ratio as may be agreed upon. In other words this concept gives recognition to the working partners as a class and authorising remuneration for the class rather than identifying or designating individual working partners and authorising remuneration for each individual working partner. There is nothing in the section 40(b) which prohibits this type of interpretation. However in order to avoid litigation it is better that the deed identifies and designates the working partners as well as the remuneration payable to them.

As a result of this stipulation every firm constituted on or after April 1, 1992 will have to provide for an appropriate clause in its partnership deed satisfying this requirement. However, so far as the existing firms are concerned, they will have to execute a supplementary deed or a deed of change in the constitution so as to incorporate a clause within the deed of partnership relating to payment of remuneration to its working partners.

(3) **It should not pertain to period prior to partnership deed:** By virtue of a further restriction contained in 40(b)(iii), such remuneration paid to the working partners will be allowed as deduction to the firm from the date of such partnership deed and not from any period prior thereto. Consequently, if for instance a firm incorporates the clause relating to payment of remuneration to the working partners by executing an appropriate deed as on July 1st, but effective from April 1st, the firm would get deduction for the remuneration paid to its working partners from July 1st onwards but not for the period from April 1st to June 30th. In other words it will not be possible to give retrospective effect to oral agreements entered into vis-a-vis such remuneration prior to putting the same in a written partnership deed.

Example: A and B entered into partnership agreement on April 1, 2009. As per the deed, each of them will be entitled to salary of Rs.2,000 per month apart from profit. On August 1, 2009 they executed a supplementary deed by which they increased the remuneration to Rs.3,000 each effective from 1st April 2009. Discuss the validity of the supplementary deed.

Remuneration will be payable effective from the date of the deed which provides for the payment of such remuneration. In the given case, the original deed provides for remuneration at the rate of Rs.2,000 for each partner from April 1, 2009 onwards. The supplementary deed is executed on August 1, 2009 increasing the limit of remuneration. Such increase in the limit of remuneration will be allowable only from 1st August 2009, being the date of supplementary deed. Hence, for the period from 1st April 2009 to 31st July 2009, the partners will be allowed remuneration only at the rate of Rs.2,000 per month.

(4) **It should not exceed the permissible limit:** As we have seen earlier, salary, bonus, commission or other remuneration may be paid to any working partner in accordance with and as authorised by the terms of the partnership deed and in relation to any period falling after the partnership deed. However, the maximum amount of such payment to all the partners during the previous year should not exceed the limits given below:-

On the first Rs.3 lakh of book profit or in case of loss, the limit would be the higher of Rs.1,50,000 or 90% of book profit and on the balance of book profit, the limit would be 60%.

Book Profit: The permissible remuneration is to be computed as a percentage of book profit. For this purpose we have to draw up the profit and loss account and find the net profit. This profit and loss account is to be prepared in the manner laid down in Chapter IVD of the Act. It may be noted that Chapter IV D of the Act contains the provisions relating to computation of income under the head 'profits and gains of business or profession'. Further Explanation 3 also lays down that if while arriving at the above net profit, the remuneration paid/payable by a firm to its partners is debited to such a profit and loss account, the aggregate of such remuneration paid/payable to the partners shall be added to the net profit in order to arrive at the book profit.

When the Act says that the profit and loss account should be prepared in the manner laid down in Chapter IVD, it means that only those items which are chargeable under section 28 as income will be taken into account and only deductions permissible thereunder will be allowed. For example, rent from house property, dividend, interest on bank deposit or government securities are not chargeable as income from business or profession under section 28. Therefore if the profit and loss account of a firm contains these above receipts they have to be excluded while calculating the net profit. In the same way items which are to be disallowed under the various provision from section 28 to 44D will have to be eliminated. It naturally follows, therefore, that brought forward business losses will not be deducted while calculating book profit.

The above table shows the upper limits up to which deduction is allowed to firm in respect of the remuneration paid to its working partners. It does not mean that a firm is prohibited from paying remuneration beyond these limits. A firm can pay remuneration to working partners beyond these limits but it will suffer disallowance in respect of such excess under section 40(b) and consequently pay tax on it at the maximum marginal rate as per section 167A. If a firm pays remuneration to non-working partners the same will be the result. However the above limits apply to the remuneration paid to the group of all working partners in a firm taken together and not to each individual partner. Finally, it may be noted that section 40(b) does not compel a firm to pay remuneration to its working partners. It is purely at the discretion of the firm. But once a firm pays remuneration to its working partners it will be subject to the restrictive provisions of section 40(b). It is also open to a firm to pay salary only to a few working partners and not all the working partners.

13.22 Income Tax

- **Applicability of section 40A(2) to remuneration payable to the partners:** Under the provisions of section 40A(2) the Assessing Officer can disallow any expenditure if he feels that such expenditure is excessive or unreasonable having regard to the fair market value of the goods, services or facility for which the payment is made. It appears that the above restrictive provisions of section 40A(2) can be taken recourse to by the Assessing Officer if he feels that such remuneration is excessive having regard to the services performed by the concerned working partner.
- **Interest payable to partners**: So far as allowability of interest paid by a firms to its partners under section 40(b) is concerned the following conditions have been prescribed by section 40(b):

  (1) The interest payable by a firm to its partners should be authorised by and in accordance with the partnership deed.

  (2) The interest payable by a firm to its partners should not be for a period falling prior to the date of such partnership deed authorizing the payment of such interest.

  (3) The rate of interest payable to the partners shall not exceed 12% simple interest per annum.

Apart from the above conditions the conditions prescribed by section 36(1)(iii) and section 40(a)(i) should also be satisfied. Section 36(1)(iii) provides that the amount of interest paid in respect of capital borrowed must be for the purposes of the business or profession. Section 40(a)(i) provides that any interest which is payable outside India will not be allowed as a deduction unless tax has been deducted therefrom.

An important question could be regarding the amount with reference to which this interest @12% will have to be calculated. For example, a partner may have contributed capital to the firm and in addition may also advance loan to the firm. The question would be whether the interest paid by the firm on capital would be allowable or that on the loan would be allowable. Moreover, some firms have an accounting system of maintaining current accounts of partners in addition to the capital accounts. When some balance is standing to the credit of a partner in such current account as well the question arises whether the interest paid on the balance in the current account will be allowable within the meaning of section 40(b).

In this regard it may be noted that section 40(b) does not refer to nor does it make any distinction between the capital contributed by a partner to the firm, the loan advanced by a partner to the firm or the balance in the current account of a partner. Therefore, the interest paid by a firm to its partners on the credit balance standing in all the accounts/whether in capital account, loan account or current account, shall be allowed as deduction to the firm under section 40(b). The idea seems to be to allow interest on the funds employed in the firm by a partner.

As it happens many times a partner may have debit balance in his current account and credit balance in his capital account or loan account. The question which would arise in such a situation could be whether the interest payable to such a partner at the rate of interest authorised by and in accordance with partnership deed will be reckoned with reference to the aggregate of the credit balance in the capital account and the loan account including the debit balance in the current account or whether it should be calculated on the net balance that is the aggregate of the credit balance in the capital account and in the loan account as reduced by the debit balance in the current account. It appears that in such a situation the equitable principle would be to allow interest reckoned with reference to the net balance. Alternatively, if interest is recovered from a partner on the debit balance in his account and interest is paid to the same partner on the credit balance in his account, the net amount paid to that partner would be subjected to the provisions of section 40. However, interest received from one partner cannot be set-off against interest paid to another partner under this proviso.

The next issue which is to be considered here is the point of time at which interest should be credited to the partners' accounts. For example, a firm may adopt a policy of crediting interest quarterly to the credit of the partners' accounts. In such a case, the firm would be paying in effect interest on interest at the year end. This would amount to compounding interest quarterly. This is not permitted under section 40(b) because what that section contemplates is simple interest and simple interest here would mean interest which is calculated yearly or annually. Paying the interest on interest credited periodically during a year would be contrary to the concept of simple interest per annum.

- **Partner in a representative capacity**: If an individual is a partner in a firm in a representative capacity (that is on behalf and for the benefit of another person) and not in his personal capacity then interest paid by the firm to such individual in his personal capacity and not as a representative partner will not be subject to the conditions and ceiling as prescribed for disallowance. But interest paid by the firm to such individual as representative partner or person represented shall be subject to the conditions and ceiling as prescribed (Explanation 1).

  Example: X is a partner in a firm in a representative capacity for and on behalf of his HUF. Supposing the firm pays interest of Rs.6,000 to X in his personal capacity and not in his capacity as the representative of HUF, it will be allowed as deduction and the prescribed ceiling will not apply. But if such payment is made to X as a representative and partner or if the firm has paid the interest directly to the HUF, then the payment will be subject to the conditions and ceiling as prescribed.

- **Interest received by a non-representative partner**: If interest is paid to an individual partner who is not the representative partner and the interest received by him is on behalf of or for the benefit of another person, then such interest payment shall be allowed without applying the ceiling limits.

Example: X is a partner of a firm in his individual capacity and is not a representative partner. Interest is paid by the firm to him in respect of a deposit made by his wife. This will be allowed as a deduction because such interest in not received by him any representative capacity but purely on behalf of another person.

- **Computation of income of partner of a firm (PFAS)**: While computing the income of a partner including a minor partner of a firm the following points have to taken into consideration.

  Share income exempt under section 10(2A): The partner's share in the total income of firm (PFAS) will be exempt in his hands and will not be included in his total income. His share in the total income of the firm will be calculated as follows:-

$$\text{Total income of firm} \times \frac{\text{Partner's share in profits of firm as per partnership deed}}{\text{Total profit of the firm}}$$

  By virtue of this exemption a partner of PFAS will not be taxed in respect of his share in the firm's income since the firm itself will be taxed as a separate entity at the maximum marginal rate. There will be no allocation of income among the partners. Because of this exemption, he will not be entitled to set-off his share in the firm's loss against his other personal income.

- **Chargeability of remuneration and interest**: Remuneration and interest received by a partner of a PFAS in accordance with the conditions prescribed under section 40(b) will be taxable in his hands as income from profits and gains of business or profession.

  If remuneration or interest paid to a partner is disallowed in the assessment of the firm due to the fact that they are not in accordance with the conditions prescribed under section 40(b) then the partner will not be taxed in respect of the amount because in such a case the firm itself will be liable to pay tax on the amount which has been disallowed in its assessment. In other words, if the firm is given the benefit of deduction of remuneration and interest paid to a partner then the liability to tax in respect of such amount will be that of a partner. If the firm is not given the benefit of deduction because of the non- compliance with the provisions of section 40(b) then the firm itself will be liable in respect of the amount and the partner will not be taxed in respect of it in his personal assessment. It is obvious that such remuneration or interest which has been disallowed in the hands of the firm but actually received by a partner will be assumed to be his share in the income of such firm and exemption under section 10(2A) will operate.

  Suppose a portion of the remuneration and interest in the assessment of the firm is disallowed since they exceed the overall ceiling limit prescribed under section 40(b),

the question arises as to how to allocate such disallowance in the hands of the partner. One reasonable basis is to assume that the remuneration and interest paid to the partners concerned has been disallowed in proportion to the gross remuneration and interest paid to them and the exemption of the disallowed sum should be available to the partners in the same proportion.

- **Rates of tax:** A PFAS will be chargeable in respect of its total income at the maximum marginal rate of 30% plus education cess@2% plus secondary and higher education cess@1% thereon.
- **Treatment of losses**: If PFAS incurs any loss the firm alone can set off and forward such losses to be set off against income of the subsequent years. The firm will not allowed to apportion its unabsorbed losses among its partners.
- **Set off of carry forward loss in case of change in the constitution of the firm [Section 78]**: If there is a change in the constitution of the firm the loss of a retired/deceased partner can be carried forward by the firm only to the extent that it does not exceed such partner's share in the profits of the firm of the relevant previous year. It does not matter whether it is a PFAS firm or PFAOP firm. However, it is to be carefully noted that section 78 is applicable only in case there is a change in the constitution of the firm as result of retirement or death of a partner in the previous year. In other words it does not apply when there is a change in the profit sharing ratio or change in the constitution because of induction of a new partner. Similarly, section 78 will not apply to set off and carry forward of unabsorbed depreciation etc.

  Section 167A: In the case of a firm which is assessable as a firm, tax shall be charged at the rate as specified in the Finance Act of the relevant year.

  Section 167C: *New section 167C provides for the liability of partners of LLP in liquidation. In case of liquidation of an LLP, where tax due from the LLP cannot be recovered, every person who was a partner of the LLP at any time during the relevant previous year will be jointly and severally liable for payment of tax unless he proves that non-recovery cannot be attributed to any gross neglect, misfeasance or breach of duty on his part in relation to the affairs of the LLP. This provision would also apply where tax is due from any other person in respect of any income of any previous year during which such other person was a LLP.*

13.4.3 Association of persons (AOP) including partnership firms assessed as AOP (PFAOP): Section 2(31) defines "person" as including "association of persons" or a body of individuals. The expression association of persons is to be understood in its ordinary sense meaning there by a group or congregation of persons. The expression association of persons is of a wider connotation and scope than that of a body of individuals. An association of persons may have as its members not only individuals (including minors)

but also companies, firms, joint families and other associations. When there is a group of persons formed for the promotion of an enterprise or when co-adventures join together in a common action they are assessable as an association of persons provided they did not in law constitute a partnership. Ordinarily, there can be no association of persons in business unless the members of the group join together out of their own volition or will.

In order to constitute an association of persons the members thereof must join any common purpose or common action and the object of the association must be to produce income. Mere receipt of income by a group of members in common will not make it an association unless income is earned by its own effort in common. For this reason appointing of a common agent, manager or lessee will not make the owners assessable as an association of persons. Thus, where the income does not arise to the group of members from any joint venture or joint activities the group of persons cannot be assessed as an association of persons. The most important features of an association of persons are that -

(i) the number of members is not restricted and

(ii) the shares of each member or group of members is not definite and ascertainable.

The co-owners, co-legatees and joint receivers joining for a common purpose or action would be assessable as an association of persons. For example, if the funds of a number of beneficiaries are put together and one business is carried on with the combined resources by the trustee, guardian or administrator, the business must be regarded as a single business assessable in the hands of an association of persons. However, section 26 specifically provides an exception to the assessment of co-owners as an association of persons. According to that section, where the shares of the co-owners in respect of income from house property are defined and ascertainable the co-owners must be assessed not as an association of persons but individually even if the property may be owned and managed and developed jointly by the co-owners. Thus, in all cases where the share of each member in group of members is definite and precisely ascertainable the assessment cannot be made as an association of persons.

For the purpose of assessment it is not necessary that the association should be legally constituted. In other words it is not necessary that there must be mutual rights and obligations amongst the members enforceable in law. The illegality, invalidity or incorrectness in the constitution of an association does not in any way affect its liability to tax or its chargeability as a unit of assessment. A partnership which is illegal or otherwise void will have to be assessed as an association of persons. The question whether there is an association of persons or not depends upon the facts and circumstances of each case.

Section 185 provides that where a firm does not comply with the provisions of section 184 for any assessment year, the firm shall be assessed as a firm and not as an AOP, which was the case earlier. However, no deduction for payment of interest, salary, bonus, commission or remuneration, by whatever name called, made by the firm to any partner

shall be allowed in computing the income chargeable under the head "Profits and gains of business or profession. However, the interest, salary, bonus, commission or remuneration so disallowed shall not be charged to tax in the hands of the partners under clause (v) of section 28.

Computation of total income of AOP/BOI and PFAOP [Section 67A]

1. Computation of total income in the case of an association of persons or body of individuals will be done in the same manner as in the case of any other assessee.
2. In computing the total income, salary, bonus, commission, remuneration or interest paid to partners/members will not be allowed.

However in the case of payment of interest the following provisions will apply:

Explanation 1: If interest is paid by an AOP/BOI to any member who was also paid interest to the AOP/BOI then only that amount of interest paid by the AOP/BOI will be disallowed in its assessment which is in excess of the interest paid by the member to the AOP/BOI.

Explanation 2: If an individual is a member of an AOP/BOI in a representative capacity, on behalf of or for the benefit of another person, then interest paid by the AOP/BOI to such individual in his personal capacity will not be taken into account for the purpose of disallowance. But interest paid by the AOP/BOI to such individual or vice-versa or representative member or interest paid by the AOP/BOI directly to the beneficiary will be taken into account for the purpose of disallowance.

Explanation 3: If interest is paid to a member who is not a member in a representative capacity but such interest is received by him on behalf of or for the benefit of another person the interest payment will be allowed.

- **Computation of tax where shares of members in AOP/BOI are unknown [Section 167B]**: Tax on the total income would be computed as follows:
  - If individual share of any partner is not known, tax will be levied at the maximum marginal rate, or at a higher rate.
  - If individual share of a partner is known but total income of any member/partner exceeds the basic exemption limit, then the firm will pay tax at the maximum marginal rate.
  - If individual share of a partner is known and no member/partner has total income exceeding the basic exemption limit, the firm will pay tax at the rates applicable to an individual.
- **Computation of member's/partner's share in the total income of association of persons/AOP firm [Section 67A]** : A member's share in the income of an association of persons/AOP firm (wherein the shares of members are determinate/known) will be computed as follows:

13.28 Income Tax

(a) Any interest, salary, bonus, commission, remuneration, etc. paid to a member/partner during the previous year will be deducted from the total income of the association, and the balance will be apportioned among the members in proportion to their respective shares.

(b) If the amount apportioned to a member/partner as per (a) is a profit, any interest, salary, etc. paid to him by the association or AOP firm during the previous year will be added to that amount and the aggregate sum will be such member's/partner's share in the income of the AOP/AOP firm.

(c) If the amount apportioned to a member/partner as per (a) is a loss, any interest, salary, etc, paid to him by the association or AOP firm will be deducted from the amount of loss and the balance sum will be such member's/partner's share in the income of the AOP/AOP firm.

The share of a member in the income/loss of the AOP/AOP firm will, for the purposes of assessment, be apportioned under the various heads of income in the same manner in which income/loss of the association has been determined under each head.

Any interest paid by a member on capital borrowed by him for the purpose of investment in the AOP/AOP firm will be allowed as deduction from share while computing his income under "Profits and gains of business or profession."

- **Assessment of share in the hands of member/partner [Section 86]:**
  - A member's/partner's share in the total income of an association of persons/AOP firm will be treated as follows:
  - If an AOP/AOP firm has paid tax at the maximum marginal rate, or a higher rate, the partner's share in the total income of the firm will not be included in his total income and will be exempt.
  - If the AOP/AOP firm has paid tax at regular rates applicable to an individual, the member's/partner's share in the income of the association/AOP firm will be included in his total income for rate purposes only. In other words, the member/partner will be allowed rebate at the average rate in respect of such share.

If the AOP/AOP firm has not paid tax on its total income, the member's/partner's share in the total income of the association/AOP firm will be included in his total income and taxed at regular rates.

13.5 ASSESSMENT OF COMPANIES

13.5.1 Meaning of 'Company' for purposes of income-tax: Under the Income-tax Act, the term "company" has a much wider meaning than what has been given to it under the

Companies Act. The company is considered as a 'person' for all purposes of assessment proceedings. [Section 2(iii)].

Section 2(17) of the Income-tax Act, 1961 defines a company for income-tax purposes. Accordingly, 'company' means (1) any Indian company (as defined in Section 2(26) and explained later) or (2) any body corporate, incorporated by or under the laws outside India or (3) any institution, association or body assessable as a company either under the Indian Income-tax Act, 1922 or for any assessment year commencing on or before 1st April, 1970, or (4) any institution, association, or body, whether incorporated or not and whether Indian or non-Indian which is declared by general or special order of the Central Board of Direct Taxes to be a company.

13.5.2 Tax Liability: A company is a juristic person and becomes a body corporate upon the issue of the certificate of incorporation; it is a legal person separate and distinct from the share holders. The legal personality of a company created by the statute can also be modified by legal fiction. For the purpose of income-tax, even an unincorporated association may be declared by the Board to be a company and, consequently, what is not a legal entity in the eyes of law may be assessable as a company. Even companies which have no share capital and those which are limited by guarantee are companies for purposes of the Income-tax Act even though the general framework of the Act mainly contemplates companies with share capital. A chamber of commerce or any association without a profit motive and registered under section 25 of the Companies Act, 1956 would be company for income-tax purposes. The tax-liability of such non-profit making associations arises in respect of the profits from specific services to their members under section 28(iii). A company incorporated for a purpose other than that of carrying on a business, a company in liquidation, a statutory corporation, the Government of any State carrying on a trade or business would be deemed to be a company within the meaning of the income-tax Act for the purposes of levy and collection of tax on the business profits assessable to Income-tax. However, an assessment cannot be made on a company after it has ceased to exist and has been struck off the register of companies. Holding companies and their subsidiaries have to be separately assessed in respect of their profits since they are separate and distinct legal entities.

- **Piercing the corporate veil:** Since the law does not prescribe any minimum number of shares to be held by a shareholder nor a maximum, even a one-man company is a distinctly assessable legal entity as much as any other company. However the income-tax authorities are entitled to examine the genuineness and the true nature of the connected transactions of such a company. A company being a separate legal entity, the mere fact that only one individual is beneficially interested in all the shares and that the company, in effect, acts as his agent or nominee will not, by itself make its income the income of the shareholder. However, the Assessing Officer can tax the shareholders after examining the genuineness of such one-man companies on the

basis of the true nature of the transaction e.g., when dividends are disguised as loans, when the company is doing the business of the individual who controls it.

As the Supreme Court has observed in *CIT vs. Shri Meenakshi Mill Ltd. (1967) 63 ITR 609.* "It is true that from the juristic point of view the company is a legal personality entirely distinct from its members, and the company is capable of enjoying rights and being subjected to duties which are not the same as those enjoyed or borne by its members. But in certain exceptional cases, the Court is entitled to lift the veil of corporate entity and to pay regard to the economic realities behind the legal facade. For example, the Court has power to disregard the corporate entity if it is used for tax evasion or to circumvent a tax obligation".

A foreign company or association which desires that the status of a 'company' be accorded to it, for purposes of assessment under the Income-tax Act, must apply to the Central Board of Direct Taxes for such a status to be vested in it. Generally, the Board agrees to grant such a status to every foreign body corporate or association possessing the usual characteristics of a company limited by shares and having a separate legal personality recognised by the laws of the country in which the body corporate or association has its registered office. However, since the purpose in obtaining the status of company obviously is to obtain a reduction in the rate of tax at which the body corporate or association would be otherwise taxed, before any foreign body corporate or association is invested with the status of a company, the Central Board of Direct Taxes would examine the loss of revenue that such a concession would involve.

- **Liability of shareholders distinct:** Since the company itself is chargeable to tax on its income as a distinct taxable entity, it pays the tax in the discharge of its own liability and not on behalf of or as the agents of the shareholders as was held by the Supreme Court in *Howrah Trading Co. Ltd. vs. CIT. (1959) 36 ITR 216* and *Purshotamdas vs. CIT (1963) 48 ITR 206*. Consequently, the shareholders whether corporate or non-corporate, are liable to tax in respect of the gross dividend (other than dividends referred to in section 115-O) without any credit for the tax assessed in the hands of the company unless a specific provision is made in the Act to the contrary. Where the tax payable by the shareholders is deducted at source from the dividends or other items of income under sections 192 to 195 of the Act, the tax is deemed to have been deducted and paid by the company on behalf of the recipient shareholders of the income and credit for same shall be given to them in their individual assessments.

13.5.3 Classes of Companies

- **Indian Company [Section 2(26)]:** An Indian company means a company formed and registered under the Companies Act, 1956 and includes:

(a) a company formed and registered under any law relating to companies formerly in force in any part of India (other than the State of Jammu and Kashmir) and the Union territories specified in (c) below:

(b) in the case of the State of Jammu and Kashmir a company formed and registered under any law for the time being in force in that State;

(c) in the case of any of the Union Territories of Dadra and Nagar Haveli, under any law for the time being in force in that Union Territory; and

(d) any corporation established by or under a Central, State or Provincial Act and having its registered or principal office in India, and also any institution, association or body which is declared by the Board to be a company under section 2(17) where the principal office of the institution , association or body is in India.

It is, however, essential that in all cases the registered, or as the case may be, the principal office of the company, corporation, institution, association or body must be in India.

- **Domestic and Foreign:** The Income-tax Act as well as rate structure classifies companies into two groups, viz. (1) Domestic company (2) Foreign company. Domestic company is one which is an Indian company or any other company, which, in respect of its income liable to tax under the Income-tax Act, has made the prescribed arrangements for the declaration and payment within India of the dividends including dividends on preferential shares payable out of such income [Section 2(22A)]. A company that is not a domestic company is a foreign company [Section 2(23A)].

- **Closely-held and widely-held:** Domestic companies are again divided into broad groups, viz (1) companies in which public are substantially interested and (2) companies in which public are not substantially interested. The former type of companies are also referred to as 'widely-held companies' while the latter are also referred to as 'closely-held companies'.

  To determine whether a company is one in which the public are substantially interested, one has to apply the tests laid down in section 2(18). Briefly, the following companies fall under this category:

  (1) companies owned by the Government or the Reserve Bank of India or in which not less than 40% of the shares are held by the government or the Reserve Bank of India or a corporation owned by that bank

  (2) companies registered under Section 25 of the Companies Act, [i.e.a company having as its object the promotion of commerce, arts, science, religion, charity or any other useful object and which prohibits payment of dividends to its members,

  (3) companies having no share capital but declared by the Board to be companies in which the public are substantially interested,

(4) mutual benefit finance company i.e. a company which carries on, as its principal business, the business of acceptance of deposits from its members and which is declared by the Central Government under section 620A of the Companies Act, 1956 to be a Nidhi or Mutual Benefits Society,

(5) public limited companies whose shares are quoted in the stock exchange and

(6) public limited companies whose equity shares carrying not less than 50% (40% in the case of industrial companies) of the voting power have been allotted unconditionally to or acquired unconditionally by and were throughout the relevant previous year beneficially held by the Government or statutory corporation or other widely-held companies or their subsidiaries, whose entire share capital has been held by the parent company throughout the previous year.

(7) Companies whose equity shares carrying not less than 51% of the voting power were throughout the relevant previous year held by one or more co-operative societies.

Thus, it should be noted that all public limited companies must automatically be treated as companies in which public are substantially interested, whereas all private limited companies will be treated as companies in which public are not substantially interested.

- **Relevance of the above classification:**

(1) All domestic companies are taxed at 30% while a non-domestic company will be taxed at 50% and 40% depending upon the composition of its total income. A surcharge of 10% of the tax payable is to be charged in the case of domestic companies and 2.5% of tax payable in the case of foreign companies, if the total income exceeds Rs.1 crore.

(2) The question as to whether a company is one in which public are substantially interested or not is relevant for determining the application of sections 2(22)(e) and section 79 also.

- **Special Provisions:** There are certain special provisions which are applicable only to companies in which public are not substantially interested. These relate to the provisions governing deemed dividend under section 2(22)(e), carry forward of losses under section 79, liability of directors under section 179 and liability to wealth tax in case of closely held companies.

13.5.4 Tax liability of a company: A company is chargeable to income-tax on its total income that had accrued or arisen in the previous year calculated under the different heads of income and in accordance with the basic principles explained in the initial

chapters of the book. The determination of the total income of a company is dependent on whether or not the company was resident in India during the relevant previous year.

Chapter 2 discusses in detail as to how the residential status of a company is to be determined and it also explains how to determine the scope of total income of company under section 5. Students are also advised to study the provisions of section 9 explained in that chapter which has much relevance to company taxation.

Thus we may conclude that the liability of a company to tax depends on the following:

(a) Whether it is an Indian company as defined in section 2(26)?

(b) Whether the company has made the prescribed arrangements for the declaration and payment of dividends within India or not (Rule 27)?

(c) The pattern of its shareholding: Is it a company in which the public are substantially interested or a subsidiary of such a company?

13.5.5 Flat rates and no initial exemption: Companies are taxed at flat rates, as stated above, as distinguished from the progressive rates of taxes applicable to individuals and Hindu undivided families. The initial exemption from tax available to these entities does not apply to companies.

13.5.6 Tax on income from life insurance business: Section 115B provides for a concessional rate of tax for taxing the profits and gains derived from the business of life insurance. Under these provisions, in the case of an assessee whose total income includes any profits and gains derived from the business of life insurance computed in accordance with the First Schedule to the Income-tax Act the income-tax payable shall be the aggregate of (i) the amount of income-tax calculated on the income from life insurance business included in total income at the rate of 12½% and (ii) the amount of income-tax with which the assessee would have been chargeable had the total income of the assessee been reduced by the amount of profits and gains from the life insurance business. Surcharge is also payable on the income-tax calculated under section 115B as in the case of other companies. In addition to the tax computed as above, the corporation shall be liable to deposit an amount equal to 33⅓% of the tax in notified social security funds.

Taxation of investment income/loss of Non-life insurance business [Rule 5 of the First Schedule to the Income-tax Act]

The profits and gains of non-life insurance business has to be determined in the manner laid down under section 44 read with Rule 5 of the First Schedule. Rule 5 requires that the profits disclosed in the annual accounts, after adjustments for unexpired risk and disallowances under sections 30 to 43B be taken as the profits and gains of non-life insurance business. Reference is made to the annual accounts, copies of which are required under the Insurance Act, 1938, to be furnished to the Controller of Insurance.

13.34 Income Tax

In the year 1999, the Insurance Act, 1938 was amended and the Insurance Regulatory Development Authority (IRDA) was created. In the financial year 2001-02, IRDA introduced "IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2002". The regulations required fresh guidelines and formats for preparation of accounts by General Insurers. The new norms required a non-life insurance company to include profit or loss on realization/sale of investment in the profit and loss account or revenue account. This treatment is also in line with the international best practice on taxation of investment income of non-life insurance companies.

Accordingly, Rule 5 of the First Schedule to the Income-tax Act now provides that the profits and gains of non-life insurance business would be the profit before tax and appropriations as disclosed in the profit and loss account prepared in accordance with the provisions of the Insurance Act, 1938 or the IRDA Act, 1999, after adjustment for unexpired risk and disallowances under sections 30 to 43B. Further, any increase in respect of any amount taken credit for in the accounts on account of appreciation of or gains on realisation of investments in accordance with the regulations prescribed by IRDA shall be treated as income and included in the computation of the total income. Similarly, deduction shall be allowed in respect of any amount either written off or provided in the accounts to meet diminution in or loss on realisation of investments in accordance with the regulations prescribed by IRDA.

Note – Since this amendment is effective only from A.Y.2011-12, it is not applicable for students appearing in May 2010 and November 2010 examinations.

13.5.7 Taxation of non-resident companies: The rates at which tax would be payable by such a company on the different categories of its income are stated above. A non-resident company which operates through an Indian branch would also be liable to pay tax on the prescribed rate on its income derived from a branch of India. When non resident company declares dividends outside India, then non-resident shareholders of such company would not have to pay any tax in India on their individual income even though the dividends would have been declared out of profits made by the company in India.

Foreign companies deriving income from royalties, patents, licence fees and fees for technical services in India are liable to be taxed in India. In the case of fees for technical services rendered, only that portion of income which relates to the services rendered in India is liable to tax in India and that received for services rendered outside India is not so liable. In respect of the income arising to a foreign company in India by way of royalties or fees for technical services rendered, the rate of tax is 50% if the royalties or fees are received from Government or an Indian concern pursuant to an agreement approved by the Government of India. The agreement in question which gives rise to the income should have been approved by the Government after 31st March, 1961 in the case of royalties and after 29th February, 1964 in the case of fees for rendering technical services but before 1.4.1976 in both cases.

♦ **Special rates of tax for taxing dividends, fees for technical services and royalties in the case of foreign companies [Section 115A]**

1. Where the income of a non-resident non-corporate assessee or a foreign company consists of -

   (i) dividends (other than dividends referred to in section 115-O)

   (ii) interest received from Government or from an Indian concern on monies borrowed or debt incurred by the Government or the Indian concern in foreign currency; or

   (iii) income received in respect of units purchased in foreign currency of a mutual fund specified under clause 23D of section 10 or of the Unit Trust of India,

   the same will be taxed at 20%. The remaining income would be chargeable at the normal rate/rates of tax.

2. No deduction in respect of any expenditure or allowance shall be allowed to the assessee under sections 28 to 44C in computing the aforesaid income. Further, where the gross total income of these assessees consists only of incomes mentioned in (i) to (iii) above, no deduction shall be allowed to them under Chapter VIA of the Income-tax Act. Further, where the gross total income includes the aforesaid incomes, Chapter VIA deductions will be allowed as if the gross total income as so reduced were the gross total income of the assessee.

3. It shall not be necessary for the aforesaid assessees to furnish a return of their income under section 139 if the total income in respect of which they are assessable under the Act during the previous year consisted only of the income referred to at (i) to (iii) above, and the tax deductible at source has been deducted from such income.

4. Where the total income of a non-corporate non-resident or a foreign company includes royalty or fees for technical services, other than income referred to in section 44DA(1), received from Government or an Indian concern in pursuance of an agreement made by the foreign company after 31.3.1976, the same will be taxed at the rates specified below subject to the following conditions:

   (a) such agreement must be made with an Indian concern ;

   (b) the agreement must be approved by the Central Government, or

   (c) where it relates to a matter included in the industrial policy for the time being in force the Government of India, the agreement should be in accordance with that policy.

   The rate of tax would be as follows –

   (i) 30% if the agreement is made on or before 31.5.97;

(ii) 20% if the agreement is made after 31.5.97 but before 1.6.2005;

(iii) 10% if the agreement is made on or after 1.6.2005.

- **Tax on income from units purchased in foreign currency or capital gains arising from the transfer [Section 115AB]**

1. Where the total income of an overseas financial organisation (Off-shore Fund) includes the following incomes namely:

   (a) income received in respect of units purchased in foreign currency, or

   (b) income by way of long term capital gains arising from the transfer of units purchased foreign currency,

   the same will be taxed at the rate of 10%.

2. Where the gross total income of the off-shore fund consists only of income from units or income by way of long-term capital gains arising from the transfer of units or both, no deduction will be allowed to the assessee under sections 28 to 44C or under section 57 or under Chapter VIA. The provisions of the second proviso to section 48 will not apply to any long-term capital gains arising from the transfer of units purchased in foreign currency.

3. Where the gross total income consists of the aforesaid income as well as other income, the deductions under Chapter VIA shall be allowed only on that portion of the gross total income which does not include income from units purchased in foreign currency.

4. For the purposes of this section, 'Overseas financial organisation' or 'off-shore fund' means any fund, institution, association or body, whether incorporated or not, established under the laws of a foreign country, which has entered into an agreement for investment in India with any public bank or public financial institution or a mutual fund specified under section 10(23D). Such arrangement must be approved by SEBI.

- **Tax on income from bonds or shares purchased in foreign currency or capital gains arising from their transfer [Section 115AC]**

1. Where the total income of a non-resident includes the following types of income namely,

   (a) income by way of interest on bonds of an Indian company issued in accordance with such scheme as may be notified by the Government or on bonds of a public sector company, sold by the Government, and purchased by him in foreign currency; or

   (b) income by way of dividends (other than dividends referred to in section 115-O) on Global Depository Receipts

      (i) issued in accordance with such scheme as the Central Government may specify

against the initial issue of shares of an Indian company and purchased by him in foreign currency through an approved intermediary; or

(ii) issued against the shares of a public sector company sold by the Government and purchased by him in foreign currency through an approved intermediary; or

(iii) issued or re-issued against the existing shares of an Indian company purchased by him in foreign currency through an approved intermediary in accordance with a specified scheme; or

(c) income by way of long-term capital gains arising from the above bonds or shares.

The income-tax will be at the rate of 10% on the above income.

2. Where the gross total income includes interest or dividends in respect of bonds or shares referred to in this section, no deduction shall be allowed to him under sections 28 to 44C or under section 57 or under Chapter VIA.

3. Where the gross total income includes interest or dividend (other than dividends referred to in section 115-O) or income by way of long-term capital gains, such gross total income shall be reduced by the amount of such income and Chapter VIA deduction will be allowed on such balance.

4. The indexation provisions contained in the first and second proviso to section 48 shall not apply for the computation of long-term capital gain arising out of the transfer of bonds or shares.

5. Where the total income of the non-resident consists only of interest or dividends on bonds and GDRs and tax has been deducted at source from such income, he need not file a return under section 139(1).

6. Where the assessee acquired Global Depository Receipts or bonds in an amalgamated or resulting company by virtue of its holding Global Depository Receipts or bonds in the amalgamating or demerged company (as the case may be) these provisions shall apply to such Global Depository Receipts or bonds.

♦ **Tax on income from GDRs purchased in foreign currency [Section 115ACA]:** This section applies to resident individuals who are employees of an Indian company engaged in specified knowledge based industry or service, or its subsidiary engaged in specified knowledge based industry or service.

Sub-section (1) of the section provides that the income-tax payable shall be the aggregate of (i) ten per cent of the income by way of dividends (other than dividends referred to in section 115-O) in respect of Global Depository Receipts of an Indian company purchased in foreign currency in accordance with such employees' stock option scheme as the Central Government may, by notification in the Official Gazette, specify in this behalf, if any, (ii) ten per cent in case of long-term capital

gains arising from the transfer of the aforesaid Global Depository Receipts, if any, and (iii) the amount of income-tax on the total income as reduced by the aforesaid income from the said Global Depository Receipts.

Sub-section (2) of the section provides that in the case of the aforesaid resident employee, no deduction shall be allowed under any provisions of this Act where the gross total income consists only of income from Global Depository Receipts. However, where the total income includes income from Global Depository Receipts, the deduction under any provisions of the Act shall be allowed as if the gross total income does not include the income from the Global Depository Receipts.

Sub-section (3) of the section provides that the first and second provisos of section 48 relating to the computation of capital gains shall not apply in case of transfer of Global Depository Receipts of an Indian company purchased by the resident employee in foreign currency. In other words, no indexation will be available even if the assets are long term capital assets.

The *Explanation* to the section defines the related expressions as follows :

(a) "Global Depository Receipts" means any instrument in the form of a depository receipt or certificate (by whatever name called) created by the Overseas Depository Bank outside India and issued to non-resident inventors against the issue of ordinary shares or foreign currency convertible bonds of issuing company;

(b) "Specified knowledge based industry or service" means

(i) information technology software

(ii) information technology service

(iii) entertainment service

(iv) pharmaceutical industry

(v) bio-technology industry; and

(vi) any other industry or service, as may be notified by the Central Government.

(c) "Subsidiary" includes subsidiary incorporated outside India.

(d) "Information technology service" means any service which results from the use of any information technology software over a system of information technology products for realising value addition;

(e) "Information technology software" means any representation of instructions, data, sound or image, including source code and object code, recorded in a

machine readable form and capable of being manipulated or providing inter-activity to a user, by means of automatic data processing machine falling under heading information technology products but does not include non-information technology products;

(f) "Overseas Depository Bank" means a bank authorised by the issuing company to re-issue Global Depository Receipts against issue of Foreign Currency Convertible Bonds or ordinary shares of the issuing company.

- **Tax on income of Foreign Institutional Investors from securities or capital gains arising form their transfer [Section 115AD]**

This section relates to tax on income of Foreign Institutional Investors from securities or capital gains arising from their transfer.

In the case of a Foreign Institutional Investor, income-tax payable shall be the aggregate of the following:

(1) 20% of the income (other than income by way of dividends referred to in section 115-O) received in respect of securities (other than those units referred to in section 115AB).

(2) 30% of the short-term capital gains arising from the transfer of the said securities. However, the amount of income-tax payable on their income by way of short-term capital gains referred to in section 111A is to be calculated at 15%.

(3) 10% of long term capital gains arising from the transfer of the said securities.

(4) The amount of income-tax on the total income as reduced by the aforesaid items of income.

Where the gross total income consists only of income from the aforesaid securities no deduction will be allowed under sections 28 to 44C or under section 57. However, where the gross total income includes income from securities or capital gains arising from the transfer of such securities, the deduction under Chapter VIA will be allowed as if the gross total income does not include the aforesaid items of income.

The first and second provisos of section 48 relating to computation of capital gains will not apply in the case of transfer of aforesaid securities by the Foreign Institutional Investors.

- **Other special provisions:** Section 44D and 44DA incorporates special provisions for computing income by way of royalties and fees for technical services chargeable to tax in the case of foreign companies and these provisions would apply notwithstanding any thing to the contrary contained in section 28 to 44C. These provisions have been explained under the head "Profits and Gains of Business or Profession". The special provisions in respect of deduction of head office

expenditure, applicable to all non-residents contained in section 44C have also been explained. All these special provisions should be borne in mind while determining the liability of foreign companies to income-tax in India.

13.5.8 Capital Gains of companies

Special Provisions:

(1) Where the assets of a company are distributed to its shareholders in species on its liquidation such a distribution is not deemed to be a transfer made by company for purposes of capital gains tax. In the absence of this specific provision, the company would be deemed to have made capital gain on the assets transferred and would consequently be liable to tax in respect of such distribution [Section 46(1)].

Where a shareholder receives any money or assets from a company on its liquidation, he is chargeable to tax under the head 'capital gains' in respect of the money or the market value of the assets on the date of distribution, reduced by the amount of notional dividends, if any, assessed under section 2(22)(c) and the sum so arrived at shall be the full value of consideration for computation of capital gains under section 48 [Section 46(2)].

(2) Section 47 provides that the following transfers of capital assets will not be considered for the purposes of levying tax on capital gains under section 45:

(i) By a holding company to its Indian subsidiary company provided the latter holds all the share capital of the former.

(ii) By a subsidiary company to its Indian holding company provided the latter holds all the share capital of the former.

(iii) In a scheme of amalgamation, by the amalgamating company to its amalgamated Indian company.

(iv) In a scheme of amalgamation, by the amalgamating foreign company to the amalgamated foreign company subject to prescribed conditions.

(v) In a demerger, by the demerged company to the resulting company, if the resulting company is an Indian company.

(vi) Any transfer in a demerger of shares held in an Indian company by the demerged foriegn company to the resulting foreign company subject to prescribed conditions.

(vii) Any transfer or issue of shares by the resulting company, in a scheme of demerger to the shareholders of the demerged company if the transfer or issue is in consideration of the demerger.

- **Exceptions:** However, the proviso to clause (v) of section 47 provides to the effect that the exemptions at (i) and (ii) above will not apply to the transfer of capital asset

made after 29.2.1988 as stock in trade. This seeks to plug the loophole which facilitated the transferee holding/subsidiary companies to circumvent the operation of section 47A by resorting to the device of converting capital asset as stock in trade at the time of transfer itself. Now, the proviso secures that any profits derived by a holding company in a transfer of a capital asset after 29th Feb. 1988 to its wholly owned subsidiary company or vice versa will be subject to tax under the head 'capital gains' in case where the capital asset is taken over as stock-in-trade by the transferee company at the time of transfer itself.

- **Inter-corporate transfer of capital assets [Section 47A]:** Section 47A provides for the withdrawal of the exemption in respect of capital gains in certain cases covered by (i) and (ii) above. Under the provisions of Section 47(iv) the transfer of a capital asset by a company to its wholly owned subsidiary company is exempt from capital gains tax levy. Similarly section 47(v) exempts transfer from subsidiary company to holding company. The only condition for such an exemption is that the transferee company must be an Indian company.

  Section 47A provides that where the "transfer" of a capital asset between a parent company and its hundred per cent subsidiary company has been exempted from any charge to capital gains tax by virtue of provisions of clause (iv) or (v) of section 47 such exemption will be revoked in either of the two under noted cases by an order of rectification under section 155(7A) of the Income-tax Act, 1961.

  (i) Within a period of eight years from the date of the transfer the capital asset in question is converted by the transferee company into or as, stock-in-trade of its business; or

  (ii) within a period of eight years from the date of the transfer the parent company or its nominee or as the case may be, the holding company ceases to hold the whole of the share capital of the subsidiary company.

Section 43C: Section 43C(i) provides that where an asset which has become the property of an amalgamated company under a scheme of amalgamation, is sold after the 29.2.1988 as stock-in-trade, then in computing the profits and gains received from such transfer, the cost of acquisition of the asset to the amalgamating company shall be the cost of acquisition of the asset to the amalgamating company, as increased by the cost of any improvement made thereto and the expenditure incurred wholly and exclusively in connection with such transfer. This provision is intended to curb the device earlier adopted by the tax payers, under which the stock-in-trade taken over by an amalgamated company was revalued at the time of amalgamation. Prior to the insertion of this provision, the amalgamating company was not liable to tax on the difference arising on account of revaluation of the stock-in-trade at a value and the amalgamated company also reduced its tax liability on the profit accruing to it in the subsequent sale of the stock-in-trade.

13.42 Income Tax

Capital gains arising on the conversion of a partnership firm into a company or succession of a sole proprietary concern by a company are exempt subject to certain conditions specified. For a detailed discussion, students may refer to the chapter dealing with capital gains.

13.5.9 Special provisions in regard to taxation of companies:

(1) Amalgamation : The definition of the term amalgamation is contained in section 2 (1A) and the other provisions in respect of amalgamation are contained in sections 32, 35, 35ABB, 35D, 35DD, 35E, 47, 49, 55, and 72A.

(2) Demerger : The definition of 'demerger' is contained in section 2(19AA) and the related provisions are contained in sections 32, 35ABB, 35D, 35E, 47, 49, 55, and 72A.

Students may refer to chapter 6 (Profits and Gains of Business or Profession), chapter 7 (Capital Gains) and chapter 10 (Set off and Carry Forward of Losses) for detailed discussions.

13.5.10 Liability for deduction of tax at source: The principal officer of an Indian company or a company which has made the prescribed arrangements for the declaration and payment of dividends (including dividends on preference shares) within India, before making any payment in cash or before making distribution or payment to a shareholder falling within the definition of dividend in section 2(22) shall deduct from the amount of all such dividends, income tax at the rate or rates prescribed by the relevant Finance Act relating to the year in which the dividend was declared. The rates for deduction of tax at source have been specified in Part II of the First Schedule to the Finance Act.

Further, the liability of the company extends as well to the deduction of tax at source from salaries, interest on securities, interest other than interest on securities, payments to contractors or sub-contractors and other sums payable to non-residents in accordance with the provisions of the sections 192 to 206B.

Deductions available for certain expenses

1. Deduction on account of Site Restoration Fund (Section 33ABA)
2. Expenditure on scientific research (Section 35)
3. Expenditure for obtaining licence to operate telecommunication services (Section 35ABB)
4. Expenditure on eligible projects or schemes (Section 35AC)
5. Expenditure under section 35CCA
6. Amortisation of certain preliminary expenses (Section 35D)
7. Amortisation of expenditure in case of amalgamation or demerger (Section 35DD)
8. Expenditure on prospecting, etc. for minerals (Section 35E)

9. Expenditure for promoting family planning among employees [Section 36(1)(ix)]

Tax incentives on certain incomes:

1. Profits and gains from industrial undertakings, etc. engaged in infrastructure development (Section 80-IA)
2. Profits and gains from industrial undertaking other than infrastructure development undertakings (Section 80-IB)
3. Profits and gains in respect of certain undertakings or enterprises in certain special category States (Section 80-IC)
4. Profits from business of collecting and processing of bio-degradable waste (Section 80JJA)
5. Deduction in respect of employment of new workmen (Section 80JJAA)

13.5.11 Restrictions on the deductibility of certain expenditure/payments of special significance to companies:

1. Head Office expenditure in the case of non-residents (Section 44C)
2. Computation of income by way of royalties etc., in the case of foreign companies (Section 44DA)
3. Set-off of losses in the case of a company in which public are not substantially interested (Section 79).

13.5.12 Tax liability of a company in liquidation [Section 178] : This has been discussed later in this chapter under the heading 'Liability in Special Cases'. The tax implications of liquidation in the context of taxation of capital gains and in the matter of dividends have been explained in the respective chapters.

- **Liability of directors of private companies in liquidation:** Section 179 provides that when any private company is wound up and any tax is assessed on the company whether before or during the course of or after its liquidation in respect of its income of any previous year and it cannot be recovered from the company, then every person who was a director of the company at any time during the relevant previous year shall be jointly and severally liable for the payment of such tax, penalty, interest or any other sum of money assessed on the company and remaining unpaid unless he proves to the satisfaction of the Assessing Officer, that the non-recovery of the amounts cannot be attributed to any gross neglect or misfeasance of duty on his part in relation to the affairs of the company.

  Section 179 provides for the collection and recovery of tax in the case of all private companies. According to section 179, the directors of a private company would be personally liable to pay the taxes due from the company not only at the time when

the company is wound up but even in case where the company is not in liquidation. Thus, the directors of private company are jointly and severally liable for the payment of any tax due from a private company in respect of its income liable to tax in any accounting year or from any other company in respect of any income of any previous year during which time, such other company was a private company. In cases where a private company is converted into a public company and the taxes assessed in respect of any income of any year during which such company was a private company could not be recovered from the company, then any tax due in respect of the income of private company could be recovered from any of the persons who were directors of the private company before it became a public company. However, such liability of the directors has been restricted to the taxes due in respect of the assessment years commencing on or after the 1st day of April, 1963. The directors would be in a position to get away from this personal liability to pay the taxes of the company, only if it could be proved that the non-recovery of the taxes due from the private company is not attributable to any gross negligence, misfeasance or breach of duty on their part in relation to the affairs of the private company. Thus the personal liability of the directors has extended to cases of private companies which are not in liquidation and those which might have subsequently become public companies.

13.5.13 Relief to certain charitable institutions and funds in respect of certain dividends: The provisions of section 236A apply to charitable institutions or funds which hold beneficially 75% of the share capital of any company throughout the previous year and whose income from dividend is exempt from tax under section 11. The institution or fund shall be allowed a tax credit as calculated in sub-section (2) of section 236A, in respect of its income from dividends (other than on preference shares) distributed during any previous year relevant to any assessment year beginning on or after 1.4.1966, by a company 75 percent of whose shareholding throughout the relevant previous year is beneficially held by a charitable institution or fund in India, the income from dividend of which is wholly exempt from tax under section 11. The tax rebate to the institution or fund will be calculated as follows:

$$\text{The amout of tax payable by the company with reference to the relevant amount of distribution of dividends} \times \frac{\text{Dividend (other than on preference shares) received by the fund or institution from the company}}{\text{Total dividend (other than on preference shares) declared by the company.}}$$

13.5.14 Carry forward and set off of losses incurred by closely-held companies: Section 79 applies only in cases where a change in share holding has taken place in the case of company in which the public are not substantially interested. Such companies will be entitled to the benefit of carry forward and set off of any earlier year's losses in the following previous year only if on the last day of the previous year shares carrying not less than 51% of the total voting power are beneficially held by persons who beneficially held those shares on the last day of the previous year in which such loss was incurred.

The object of the section is to counter avoidance of tax by persons taking advantage of the corporate personality of the company. The section does not, however, affect the right of the company to set off its current losses against other current income nor does it affect the carry forward of unabsorbed depreciation allowance, development rebate, or investment allowance, expenditure on scientific research, patents or copyright, and expenses on the prospecting or the extraction of any mineral or group of associated minerals subject, however, to the other provisions of the Act for the carry forward and set-off of these items.

The proviso to section 79, however provides for an exception in this regard. Accordingly, carry forward and set off of past years' losses shall not be denied to a closely held company where a change in the shareholding resulting in a change in voting power to the extent of 51% or more has taken place consequent upon the death of a shareholder or gift of shares made by a shareholder to any of his relatives.

13.5.15 Prescribed arrangements for the declaration and payment of dividends within India: The arrangements (specified in Rule 27 of the Income-tax Rules) are the following:

(i) The share register of the company concerned for all its shareholders shall be maintained regularly at its principal place of business within India in respect of any assessment year from a date not later than the 1st day April of each assessment year.

(ii) The annual general meeting of the shareholders for passing the accounts of the previous year relevant to the assessment year and for declaring any dividends in respect thereof shall be held only at a place within India.

(iii) the dividends declared, if any, shall be made payable only within India to all the shareholders.

It is obligatory for Indian companies to make the prescribed arrangements stated above; non-Indian companies will be treated as domestic companies only if they make the prescribed arrangements for the declaration and payment of dividends in India.

13.5.16 Minimum Alternate Tax on companies [Section 115JB]: It is provided that in case of company (domestic or foreign) , if the income-tax payable on the total income computed under the Income-tax Act, is less than *15%* of its book profit, such book profit shall be deemed to be the total income of the assessee and the tax payable by the assessee on such total income shall be the amount of income-tax at the rate of *15%* (add surcharge, if applicable, i.e. 10% for domestic companies and 2.5% for foreign companies, where the total income exceeds Rs.1 crore) and Education cess @2% and secondary and higher education cess@1% shall be added on the aggregate of income-tax and surcharge

The book profit shall mean the net profit as shown in the profit and loss account prepared in accordance with the provisions of Part II and III of Schedule VI to the Companies Act, 1956 as adjusted by certain additions/deductions as specified.

13.46 Income Tax

The net profit shall be increased by the following amounts if debited to the profit and loss account:

(a) income-tax paid or payable, and the provision therefor; or

[It may be noted that income-tax includes –

(1) dividend distribution tax / tax on distributed income;

(2) interest;

(3) surcharge;

(4) education cess; and

(5) secondary and higher education cess]

(b) amount carried to any reserves, by whatever name called, other than any amount transferred to Special Reserve under section 33AC; or

(c) amounts set aside to provision for meeting liabilities other than ascertained liabilities; or

(d) amount of provision for losses of subsidiary companies; or

(e) amount of dividends paid or proposed; or

(f) amount of expenditure relatable to any income to which section 10 [other than section 10(38)] or 11 or 12 apply; or

(g) the amount of depreciation; or

(h) the amount of deferred tax and provision therefor; or

(i) the amount set aside as provision for diminution in the value of any asset.

The net profit shall be reduced by the following amounts:

(i) amount withdrawn from any reserve or provision, if any, such amount is credited to the profit and loss account.

However, the amount withdrawn from reserves/provisions shall not be reduced from the book profit unless the book profit of that year has been increased by those reserves/provisions;

(ii) amount of income to which section 10 [other than section 10(38)] or 11 or 12 apply, if such amount is credited to the profit and loss amount;

(iii) the amount of depreciation debited to the profit and loss account (excluding the claim of depreciation on account of revaluation of assets);

(iv) the amount withdrawn from the revaluation reserve and credited to the profit and loss account, to the extent it does not exceed the amount of depreciation on revaluation of assets;

(v) amount of brought forward loss or unabsorbed depreciation, whichever is less as per books of account. The loss shall not include depreciation; If either the figure of brought forward loss or unabsorbed depreciation is "NIL", no deduction will be allowed from the book profit of the relevant year;

(vi) amount of profits eligible for deduction under section 80HHC;

(vii) amount of profits eligible for deduction under section 80HHE;

(viii) amount of profits eligible for deduction under section 80HHF;

(ix) amount of profits of a sick industrial company (BIFR company) commencing from the previous year in which the company became sick and ending with the assessment year during which the entire net worth becomes positive. For this purpose, "net worth" shall have the same meaning as assigned under section 3(1)(ga) of the Sick Industrial Companies (Special Provisions) Act, 1985.

(x) the amount of deferred tax, if any such amount is credited to the profit and loss account.

The section also specifies that the profit and loss account for the relevant previous year has to be computed in accordance with Parts I and II of Schedule VI to the Companies Act, 1956. Further, while preparing the annual accounts,-

(i) the accounting policies,

(ii) the accounting standards followed for preparing such accounts,

(iii) the method and rates for calculating depreciation

shall be the same as have been adopted for the purpose of preparing such accounts and laid before the company at its annual general meeting.

Where the financial year adopted by the company under the Companies Act is different from the previous year under the Income-tax Act, the accounting policies, etc. adopted shall correspond to the accounting policies followed for preparing such accounts for the financial year.

The section also provides that every company to which this section applies shall furnish, along with the return of income filed under section 139(1) or in response to a notice under section 142(1)(i), a report from a chartered accountant certifying that the book profit has been computed in accordance with the provisions of this section.

It is also provided that in respect of the relevant previous year, the amounts determined under the provisions of sub-section (2) of section 32 or sub-section (3) of section 32A or clause (ii) of section 72(1) or section 73 or section 74 or sub-section (3) of section 74A, shall be allowed to be carried forward.

The provisions of MAT contained in section 115JB would not apply to the following income accruing or arising on or after 1st April 2005 –

(i) income from any business carried on by an entrepreneur in a SEZ;

(ii) income from services rendered by an entrepreneur from a unit in a SEZ;

(iii) income of a Developer from the development of a SEZ.

Set-off of credit of tax paid under section 115JB [Section 115JAA]

(1) This section provides that where tax is paid in any assessment year in relation to the deemed income under section 115JB(1), the excess of tax so paid over and above the tax payable under the other provisions of the Income-tax Act, will be allowed as tax credit in the subsequent years.

(2) The tax credit is, therefore, the difference between the tax paid under section 115JB(1) and the tax payable on the total income computed in accordance with the other provisions of the Act.

(3) The tax credit shall be allowed to be set off in a year in which tax becomes payable on the total income computed in accordance with provisions of the Act other than section 115JB.

(4) This tax credit is allowed to be carried forward for *ten* assessment years succeeding the assessment year in which the credit became allowable.

(5) Such credit is allowed to be set off against the tax payable on the total income in an assessment year in which the tax is computed in accordance with the provisions of the Act, other than 115JB, to the extent of excess of such tax payable over the tax payable on book profits in that year.

A numerical illustration:-

A.Y.	**Normal tax liability**	**Tax liability u/s. 115JB**	**Tax payable by the assessee [Higher of (2) and (3)]**	**Additional tax liability (4) - (2)**	**Credit u/s. 115JAA utilised**	**Credit available for carry forward**
(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*	*(7)*
2007-08	100	300	300	200	-	200
2008-09	120	90	120	NIL	30#	170
2009-10	150	110	150	NIL	40	130
2010-11	180	200	200	20	-	150

2011-12	200	190	200	NIL	10	140
2012-13	300	280	300	NIL	20	120
2013-14	250	230	250	NIL	20	100
2014-15	225	175	225	NIL	50	50
2015-16	250	240	250	NIL	10	40
2016-17	275	270	275	NIL	5	35
2017-18	300	295	300	NIL	5	30*

Even though credit of 200 is available, only 30 can be utilised so that the tax payable by the assessee does not go below the amount computed u/s. 115JB.

* out of the credit of 30, 10 relates to A.Y. 2007-08 and 20 relates to A.Y. 2010-11. In view of provisions of sub-section (3A) of section 115JAA, the credit of 10 will not be allowable after A.Y. 2017-18 and would accordingly lapse. However, credit of 20 pertaining to A.Y. 2010-11 would be allowed to be carried forward till A.Y. 2020-21.

13.5.17 Tax on distributed profit of domestic companies: Chapter XII D [Section 115-O]

The amounts declared, distributed or paid on or after 1.4.2003 by a domestic company by way of dividends are charged to additional income-tax at the flat rate of 15%, in addition to normal income-tax chargeable on the income of the company. Dividends received from domestic companies on or after 1.4.03 are exempt in the hands of shareholders [Sub-section (1)]

Sub-section (1A) to section 115-O seeks to provide a partial relief from double taxation of dividends. A holding company receiving dividend from its subsidiary company can reduce the same from dividends declared, distributed or paid by it. For this purpose, a holding company is one which holds more than 50% of the nominal value of equity shares of the subsidiary. However, there are certain conditions to be fulfilled to avail this benefit. They are -

- the subsidiary company should have actually paid the dividend distribution tax;
- the holding company should be a domestic company; and
- it should not be a subsidiary of any other company.

It may be noted that the matching principle does not apply i.e. dividend received from the subsidiary company during the year can be reduced from the dividend distributed by the holding company during the same year, irrespective of the period to which the dividends

relate to. Even if the dividend received and dividend distributed relate to different periods, the same can be adjusted and tax can be paid by the holding company on the net figure. However, the dividend shall not be taken into account for reduction more than once.

The Finance (No.2) Act, 2009 has exempted the NPS Trust from the applicability of dividend distribution tax in respect of dividend paid to any person for, or on behalf of, the NPS Trust. Hence, the dividend paid to any person for, or on behalf of, the NPS Trust would not be subject to dividend distribution tax. Therefore, for the purpose of calculating dividend distribution tax, a company can reduce such dividend from the dividends declared, distributed or paid by it.

Even if no income tax is payable by a domestic company on its total income computed in accordance with the provisions of Income-tax Act, the tax on distributed profits shall be payable by such company [Sub-section (2)].

This tax must be paid to the credit of the Central Government within fourteen days from the date of (a) declaration of any dividend or (b) distribution of any dividend or (c) payment of any dividend whichever is earliest [Sub-section (3)].

Section 115P provides that non-payment of dividend distribution tax within the time allowed under section 115-O(3) attracts simple interest @1% for every month or part thereof on the amount of such tax for the period beginning from the date following the date on which the tax was payable and ending with the date on which the tax is actually paid. The Principal officer of a domestic company and the company is liable to pay interest on such non-payment or delayed payment. Section 115Q provides that the principal officer and the company would be deemed to be an assessee-in-default if they fail to pay the tax in accordance with the provisions of section 115-O.

The tax on distributed profits so paid by the company shall be treated as the final payment of tax in respect of the amount declared, distributed or paid as dividends and no further credit therefore shall be claimed by the company or by any other person in respect of the amount of tax so paid [Sub-section (4)].

No deduction under any of the provisions of the Income-tax Act shall be allowed to the shareholder in respect of the dividend income [Sub-section (5)].

No tax on dividends would be chargeable in respect of the total income of an undertaking or enterprise engaged in –

(a) developing a special economic zone (SEZ); or

(b) developing and operating a SEZ; or

(c) developing, operating and maintaining a SEZ

if such dividend, whether interim or final, is declared, distributed or paid by such

Developer or Enterprise –

(a) on or after 1.4.2005

(b) out of its current income.

It is to be noted that such dividend does not attract tax either in the hands of the Developer or the Enterprise nor in the hands of the person receiving such dividend [Sub-section (6)].

13.5.18 Tax on Distributed Income of Mutual Funds [Chapter XII-E]: Chapter XII-E comprises of sections 115R, 115S and 115T.

(a) Section 115R: Any amount of income distributed by the specified company as defined in the Unit Trust of India (Transfer of Undertaking and Repeal) Act, 2002 or a Mutual Fund to its unit holders on or after 1.4.03 shall be chargeable to tax and the specified company or the Mutual Fund shall be liable to pay additional income-tax at the rate of 12.5%, if distribution is made to any individual or HUF. The rate of tax would, however, be 20% if income is distributed to any person, other than an individual or HUF. However, in case of a money market mutual fund or a liquid fund, the rate of tax on distributed profits is 25%, irrespective of whether the payee is an individual or a HUF or any other person.

	Income distributed by	**Rate of tax**
(i)	Money market mutual funds or liquid funds	25%
(ii)	Other funds -	
	on income distributed to individuals/HUFs	12.5%
	on income distributed to any other person	20%

Money market mutual fund means a means a money market mutual fund as defined in sub-clause (p) of clause 2 of the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996 i.e. it means a scheme of a mutual fund which has been set up with the objective of investing exclusively in money market instruments.

Liquid fund means a scheme or plan of a mutual fund which is classified by the Securities and Exchange Board of India as a liquid fund in accordance with the guidelines issued by it in this behalf under the Securities and Exchange Board of India Act, 1992 or regulations made thereunder.

However, this does not apply in respect of any income distributed (i) by the Administrator of the specified undertaking to the unit holders (ii) to a unit holder of equity oriented funds in respect of any distribution made from such funds.

The income from units received by a unit holder on or after 1.4.03 is exempt from income-tax.

The person responsible for making the payment of income distributed by the UTI or a

13.52 Income Tax

Mutual Fund and the UTI or the Mutual Fund itself, as the case may be, shall be liable to pay the tax under this provision to the credit of the Central Government within fourteen days from the date of distribution or payment of such income, whichever is earlier.

The person responsible for making payment of the income distributed by the Unit Trust of India or a Mutual Fund and the Unit Trust of India or the Mutual Fund, as the case may be, liable to file a statement before 15th September each year to the manner, giving the details of the amount of income distributed to unit holders during the previous year, the tax paid and other relevant details.

(b) Section 115-S: This section provides that if the person responsible for making payment of the income distributed by the specified company or a Mutual Fund and the specified company or the Mutual Fund, as the case may be, fails to pay the income-tax to the credit of the Central Government within the time allowed under section 115-R, he or it shall be liable to pay simple interest at the rate of 1% for every month or part thereof on such amount of tax which has not been paid or was not paid in time.

(c) Section 115-T: This section provides that if the person responsible for making payment of the income distributed by the specified company or a Mutual Fund and the specified company or the Mutual Fund, as the case may be, fails to pay the income-tax to the credit of the Central Government, he or it shall be deemed to be an assessee in default in respect of the amount of tax payable and all the provisions of this Act for the collection and recovery of income-tax shall apply.

Specified company, for the purpose of section 115-S and 115-T, means specified company as referred to in section 2(h) of the Unit Trust of India (Transfer of Undertaking and Repeal) Act, 2002.

The expression “Mutual Fund”, “open-ended equity oriented fund” and “Unit Trust of India” have been defined for the purposes of the newly inserted Chapter XII-E of the Income-tax Act in the Explanation as follows:

(a) “Mutual Fund” means a Mutual Fund specified under clause (23D) of section 10;

(b) “Equity oriented fund” means -

  (i) the Unit Scheme, 1964 made by the Unit Trust of India; and

  (ii) such fund where the investible funds are invested by way of equity shares in domestic companies to the extent of more than *65%* of the total proceeds of such funds, provided that the percentage of equity share holding of the fund shall be computed with reference to the annual average of the monthly averages of the opening and closing figures;

  (iii) “Unit Trust of India” means the Unit Trust of India established under the Unit Trust of India Act, 1963.

13.5.19 Tax on Income Received from Venture Capital Companies/Funds [Chapter XII-F (Section 115U)]: Chapter XII-F relates to special provisions with regard to the tax on the income distributed by venture capital companies and venture capital funds. The Chapter contains section 115U.

Sub-section (1) provides that notwithstanding anything contained in any other provisions of the Act, any income received by a person out of investments made in a venture capital company or venture capital fund shall be chargeable to income-tax in the same manner as if such income were received from investments made directly in the venture capital undertaking.

Sub-section (2) provides that the person responsible for making payment of the income on behalf of the venture capital undertaking or fund shall furnish within the prescribed time, to the person receiving such income and to the prescribed income-tax authority, a statement in the prescribed form and verified in the prescribed manner, giving details of the nature of the income paid during the previous year and other relevant details.

Sub-section (3) provides that the income paid by the venture capital company and the venture capital fund shall be deemed to be of the same nature and in the same proportion in the hands of the recipient as it had been received by or accrued to the venture capital company or fund during the previous year.

Sub-section (4) provides that the provisions of Chapter XII-D (dealing with tax on distributed profits of domestic companies - Section 115-O to 115Q), Chapter XII-E (dealing with tax on distributed income of mutual funds - Section 115R to 115T) and Chapter XVII B (dealing with deduction of tax at source) shall not apply to the income paid by a venture capital company or venture capital fund under this Chapter.

This expressions “venture capital company”, “venture capital fund” and “venture capital undertaking” for the purposes of Chapter XII-F of the Income-tax Act shall have the same meanings as assigned to them under section 10(23FB) [Please refer to Chapter 3].

13.5.20 SPECIAL PROVISIONS RELATING TO INCOME OF SHIPPING COMPANIES

To make the Indian shipping industry more competitive, a tonnage tax scheme for taxation of shipping profits has been introduced. Tonnage tax will induce more ships to fly the Indian Flag.

Chapter XII-G, containing sections 115V to 115VZC, provides for special provisions relating to taxation of the income of shipping companies. This Chapter comes into force from A.Y.2005-06. Upto A.Y.2004-05, the shipping company is assessed under the normal provisions of the Income-tax Act dealing with the computation of profits and gains of business or profession. Deduction under section 33AC was available, subject to fulfillment of the conditions mentioned therein. With the introduction of tonnage tax scheme, the companies have to exercise the option to be assessed under this scheme or under the normal provisions of the Income-tax Act. The salient features of the scheme are as follows:

13.54 Income Tax

- A company owning at least one qualifying ship may join.
- A qualifying ship is one with a minimum tonnage of 15 tons and having a valid certificate.
- An existing qualifying company has to opt for the scheme within 3 months i.e. any time between 1st October, 2004 to 31st December, 2004 by making an application in the prescribed form to the concerned Joint Commissioner who may pass an appropriate order.
- If a company is incorporated after the initial period or a company which is incorporated before the initial period but becomes a qualifying company for the first time after the initial period, this application is required to be made within three months of the date of incorporation or the date on which it becomes a qualifying company, as the case may be.

(1) COMPUTATION OF TONNAGE INCOME FROM BUSINESS OF OPERATING QUALIFYING SHIPS

Computation of profits and gains from the business of operating qualifying ships [Section 115VA]

(1) A company has the option to compute the income from the business of operating qualifying ships in accordance with the provisions of this Chapter.

(2) Such income is deemed to be the income chargeable to tax under the head "Profits and gains of business or profession" in respect of such business.

Operating ships [Section 115VB]

(1) A company shall be regarded as operating a ship if it operates any ship whether owned or chartered by it.

(2) Even if only a part of the ship has been chartered in by it in an arrangement such as slot charter, space charter or joint charter, the company would be regarded as operating a ship.

(3) However, a company will not be regarded as the operator of a ship which has been chartered out on bareboat charter-cum-demise terms or on bareboat charter terms for a period exceeding three years.

(4) "Bareboat charter" means hiring of a ship for a stipulated period on terms which give the charterer possession and control of the ship, including the right to appoint the master and crew;

(5) "Bareboat charter-cum-demise" means a bareboat charter where the ownership of the ship is intended to be transferred after a specified period to the company to whom it has been chartered;

Meaning of "Qualifying company" [Section 115VC]

(1) A company will be a qualifying company if -

(a) it is an Indian company;

(b) the place of effective management of the company is in India;

(c) it owns at least one qualifying ship; and

(d) the main object of the company is to carry on the business of operating ships.

(2) The expression "place of effective management of the company" has been defined in the Explanation to the section to mean –

(a) the place where the board of directors of the company or its executive directors make their decisions; or

(b) in a case where the board of directors routinely approve the commercial and strategic decisions made by the executive directors or officers of the company, the place where such executive directors or officers of the company perform their functions.

Meaning of "Qualifying ship" [Section 115VD]

(1) A ship is a qualifying ship if

(i) it is a seagoing ship or vessel of 15 net tonnage or more;

(ii) it is registered –

(a) under the Merchant Shipping Act, 1958; or

(b) outside India in respect of which a licence has been issued by the Director-General of Shipping under section 406 or 407 of the Merchant Shipping Act, 1958

(iii) there is a valid certificate in force indicating the net tonnage of such a ship;

(2) However, the following ships are not "qualifying ships" –

(i) a seagoing ship or vessel if the main purpose for which it is used is for the provision of goods or services of a kind normally provided on land ("seagoing ship" means a ship which is certified as seagoing by the competent authority of any country);

(ii) fishing vessels;

(iii) factory ships (which includes a vessel providing processing services in respect of processing of the fishing produce);

(iv) pleasure craft (i.e. a ship, whose primary use is for the purposes of sport or recreation);

(v) harbour and river ferries;

(vi) offshore installations;

(vii) a qualifying ship which is used as a fishing vessel for a period of more than thirty days during a previous year.

Manner of computation of income under tonnage tax scheme [Section 115VE]

(1) A tonnage tax company engaged in the business of operating qualifying ships should compute the profits from such business under the tonnage tax scheme;

(2) "Tonnage tax company" means a qualifying company in relation to which tonnage tax option is in force;

(3) "Tonnage tax scheme" means a scheme for computation of profits and gains of business of operating qualifying ships under the provisions of this Chapter.

(4) The business of operating qualifying ships giving rise to "relevant shipping income" (i.e. income referred to in section 115V-I(1)) has to be considered as a separate business, distinct from all other activities or business carried on by the company.

(5) Such profits should be computed separately from the profits and gains from any other business.

(6) The tonnage tax scheme will apply only if an option to that effect is made (in accordance with the provisions of section 115VP).

(7) The profits and gains from the business of operating qualifying ships of a company engaged in such business and –

(a) not covered under the tonnage tax scheme or,

(b) which has not made an option to that effect,

have to be computed in accordance with the other provisions of this Act.

Tonnage income [Section 115VF]

(1) "Tonnage income" means the income of a tonnage tax company computed in accordance with the provisions of this Chapter. The tonnage income has to be computed in accordance with the provisions of section 115VG given below.

(2) The income so computed is deemed to be the profits chargeable under the head "Profits and gains of business or profession".

(3) Where income is so computed under section 115VG, the relevant shipping income (referred to in section 115V-I(1)) will not be chargeable to tax.

Computation of tonnage income [Section 115VG]

(1) The tonnage income for a previous year is the aggregate of the tonnage income of each qualifying ship.

(2) The tonnage income of a qualifying ship is to be calculated on the basis of the daily tonnage income of such ship multiplied by the number of days in the previous year.

(3) In case the ship is operated by the company as a qualifying ship for only part of the previous year, the tonnage income of the ship will be calculated on the basis of daily tonnage of such ship multiplied by the number of days in part of the previous year.

(4) The daily tonnage income of a qualifying ship has to be computed as under –

Qualifying ship having net tonnage	Amount of daily tonnage income
Up to 1000	Rs.46 for each 100 tons
Exceeding 1,000 but not more than 10,000	Rs.460 plus Rs.35 for each 100 tons exceeding 1,000 tons
Exceeding 10,000 but not more than 25,000	Rs.3,610 plus Rs.28 for each 100 tons exceeding 10,000 tons
Exceeding 25,000	Rs.7,810 plus Rs.19 for each 100 tons exceeding 25,000 tons

(5) "Tonnage" means the tonnage of a ship indicated in the "valid certificate" (i.e. referred to in section 115VX) and includes deemed tonnage computed in the prescribed manner.

(6) "Deemed tonnage" means the tonnage in respect of an arrangement of purchase of slots, slot charter and an arrangement of sharing of break-bulk vessel.

(7) The tonnage is to be rounded off to the nearest multiple of hundred tons.

(8) No deduction or set-off is allowed in computing the tonnage income under this Chapter.

Calculation of tonnage income in case of joint operation [Section 115VH]

(1) Where a qualifying ship is operated by two or more companies –

(a) by way of joint interest in the ship or by way of an agreement for the use of the ship and

(b) their respective shares are definite and ascertainable,

(c) the tonnage income of each such company shall be an amount equal to a share of income proportionate to its share of interest.

(2) Where two or more companies are operators of a qualifying ship, the tonnage income of each company shall be computed as if each had been the only operator, if the conditions specified in (a) and (b) of (1) above are not satisfied.

Meaning of "Relevant shipping income"[Section 115V-I]

(1) The "relevant shipping income" of a tonnage tax company means its profits from core activities and its profits from incidental activities

(2) Where the aggregate of income from incidental activities exceeds one-fourth per cent of the turnover from core activities, such excess will not form part of relevant shipping income for the purposes of this Chapter and shall be taxable under the other provisions of this Act.

(3) The core activities of a tonnage tax company are –

(i) its activities from operating qualifying ships; and

(ii) Other ship-related activities, being,

(a) shipping contracts in respect of –

(1) earnings from pooling arrangements i.e.

(i) agreement between two or more persons for providing services through a pool or

(ii) operating one or more ships and sharing earnings or operating profits on the basis of mutually agreed terms;

(2) contracts of affreigtment i.e. a service contract under which a tonnage tax company agrees to transport a specified quantity of specified products at a specified rate, between designated loading and discharging ports over a specified period.

(b) Specific shipping trades, being, -

(1) on-board or on-shore activities of passenger ships comprising of fares and food and beverages consumed on board;

(2) slot charters, space charters, joint charters, feeder services, container box leasing of container shipping.

(4) The incidental activities of the tonnage tax company are the activities which are incidental to the core activities and which may be prescribed for the purpose.

(5) The Central Government can, by notification, exclude any activity under "other ship-related activities" mentioned in (3) above or prescribe the limit up to which such

activities can be included in the core activities.

(6) Every notification issued under this Chapter has to be laid before each House of Parliament to make the same effective.

(7) If both Houses agree in making any modification therein, the notification will have effect in such modified form.

(8) Similarly, if both Houses agree that the notification should not be issued, then such notification will be of no effect.

(9) However, such modification or annulment will not affect anything previously done under that notification.

(10) Where a tonnage tax company operates a non-qualifying ship, then the income attributable to operation of the non-qualifying ship should be computed in accordance with the other provisions of this Act.

(11) In the following cases, the relevant shipping income is to be computed as if the transfer had been at market value of the goods and services as on the date of transfer–

(i) Where any goods or services held for the purposes of tonnage tax business are transferred to any other business carried on by a tonnage tax company, or

(ii) where any goods or services held for the purposes of any other business carried on by such tonnage tax company are transferred to the tonnage tax business, and

(iii) In both the above cases, the consideration, if any, for such transfer as recorded in the accounts of the tonnage tax business does not correspond to the market value of such goods or services as on the date of the transfer,

(12) Where the computation of the relevant shipping income in the manner specified above presents exceptional difficulties, the Assessing Officer may compute such income on such reasonable basis as he may deem fit.

(13) If the Assessing Officer is of the opinion that the affairs of the business transacted between the tonnage tax company and any other person are arranged in such a manner that the company gets more than the ordinary profits which might be expected to arise in the tonnage tax business, then he may take into account the amount of income which may be reasonably deemed to have been derived therefrom for computing the relevant shipping income.

(14) The affairs of the business can be so arranged to yield more than ordinary profits owing to the close connection between the tonnage tax company and such other person or for any other reason.

(15) In case the relevant shipping income of a tonnage tax company is a loss, then, such loss is to be ignored for the purposes of computing tonnage income.

Treatment of common costs [Section 115VJ]

(1) Where a tonnage tax company also carries on any business or activity other than the tonnage tax business, the common costs attributable to the tonnage tax business should be determined on a reasonable basis.

(2) Where any asset, other than qualifying ship, is not exclusively used for the tonnage tax business by the tonnage tax company, depreciation on such asset has to be allocated between its tonnage tax business and other business.

(3) Such allocation of depreciation has to be done on a fair proportion to be determined by the Assessing Officer, having regard to the use of such asset for the purpose of the tonnage tax business and for the other business.

Depreciation [Section 115VK]

(1) The depreciation for the first previous year of the tonnage tax scheme has to be computed on the written down value of the qualifying ships.

(2) The written down value of the block of assets, being ships, as on the first day of the previous year, has to be divided in the ratio of the book written down value of the qualifying ships (qualifying assets) and the book written down value of the non-qualifying ships (other assets).

(3) The block of qualifying assets would constitute a separate block of assets.

(4) The manner of computing the book written down value of the block of qualifying assets and the block of other assets is as follows –

(a) the book written down value of each qualifying asset and each other asset as on the first day of the previous year is to be determined by taking the book written down value of each asset appearing in the books of account as on the last day of the preceding previous year;

(b) Any change in the value of assets consequent to their revaluation after 10.9.04 is to be ignored;

(c) The book written down value of all the qualifying assets and other assets are to be aggregated;

(d) The ratio of the aggregate book written down value of the qualifying assets to the aggregate book written down value of the other assets has to be determined.

(5) In case an asset forming part of the block of qualifying assets begins to be used for purposes other than the tonnage tax business, an appropriate portion of the written

down value allocable to such asset has to be reduced from the written down value of that block and added to the block of other assets.

(6) In case an asset forming part of the block of other assets begins to be used for tonnage tax business, an appropriate portion of the written down value allocable to such asset has to be reduced from the written down value of the block of other assets and has to be added to the block of qualifying asset.

(7) Depreciation on the block of qualifying assets and block of other assets so created shall be allowed as if the written down value as on the first previous year has been brought forward from the preceding previous year.

(8) The expression "book written down value" means the written down value as appearing in the books of account.

Deemed deduction and set-off and carry forward of losses etc. [Section 115VL]

(1) Any loss/allowance or deduction under sections 30 to 43B relating to or allowable for any of the relevant previous years, would be deemed to have been given full effect to in that previous year itself;

(2) No set-off or carry forward of losses referred to in –

(i) sections 70(1) and 70(3); or

(ii) sections 71(1) and 71(2); or

(iii) section 72(1) or

(iv) section 72A(1),

relating to the business of operating qualifying ships of the company is permissible where such loss relates to any of the previous years when the company is under the tonnage tax scheme;

(3) No deduction under Chapter VI-A is allowable in relation to the profits and gains from the business of operating qualifying ships;

(4) In computing the depreciation allowance under section 32, the written down value of any asset used for the purposes of the tonnage tax business has to be computed as if the company has claimed and has been actually allowed the deduction in respect of depreciation for the relevant previous year.

Set-off and carry forward of losses of tonnage tax business [Section 115VM]

(1) Any losses attributable to its tonnage tax business that have accrued to a company before its entry in tonnage tax scheme can be set off only against the relevant shipping income when the company is under the tonnage tax scheme.

(2) Such losses will not be available for set off against any income other than relevant shipping income in any previous year beginning on or after the date when the company exercises its option under section 115VP.

(3) Any apportionment necessary to determine such losses should be made on a reasonable basis.

Capital gains from transfer of tonnage tax assets [Section 115VN]

(1) Profits or gains arising from the transfer of a capital asset being an asset forming part of the block of qualifying assets is chargeable to income-tax in accordance with the provisions of section 45, read with section 50.

(2) The capital gains so arising has to be computed in accordance with the provisions of sections 45 to 51.

Book profit or loss to be excluded for the purpose of section 115JB [Section 115VO]

This section seeks to exclude the book profits or loss derived from the activities of a tonnage tax company (referred to in section 115V-I(1)) for the purposes of section 115JB.

(2) PROCEDURE FOR OPTION OF TONNAGE TAX SCHEME

Method and time of opting for tonnage tax scheme [Section 115VP]

(1) A qualifying company may opt for the tonnage tax scheme by making an application to the Joint-Commissioner having jurisdiction over the company in the prescribed form and manner.

(2) An existing qualifying company should make an application at any time after 30th September, 2004 but before 1st January, 2005, which is the initial period.

(3) In case of a company incorporated after the initial period or a company incorporated before the initial period but which becomes a qualifying company for the first time after the initial period, an application can be made within three months of the date of its incorporation or the date on which it became a qualifying company, as the case may be.

(4) The Joint Commissioner, on receipt of an application for option for tonnage tax scheme, may call for such information or documents from the company as he thinks necessary in order to satisfy himself about the eligibility of the company.

(5) After satisfying himself about the eligibility of the company to make such option for tonnage tax scheme, he can either pass an order in writing approving the option for tonnage tax scheme or, if he is not so satisfied, pass an order in writing refusing to approve the option for tonnage tax scheme.

(6) A copy of such order should be sent to the applicant.

(7) An order refusing to approve the option for tonnage tax scheme can be passed only after giving the applicant a reasonable opportunity of being heard.

(8) Every order granting or refusing the approval of the option for tonnage tax scheme should be passed before the expiry of one month from the end of the month in which the application was received.

(9) Where an order granting approval for tonnage tax scheme is passed, the provisions of this Chapter will apply from the assessment year relevant to the previous year in which the option for tonnage tax scheme is exercised.

Period for which the tonnage tax option will remain in force [Section 115VQ]

(1) An option for tonnage tax scheme (after it has been approved under section 115VP(3)) would remain in force for a period of ten years from the date on which such option has been exercised.

(2) For this purpose, the option would be taken into account from the assessment year relevant to the previous year in which such option is exercised.

(3) An option for tonnage tax scheme would cease to have effect from the assessment year relevant to the previous year in which –

(i) the qualifying company ceases to be so or

(ii) a default is made in complying with the provisions contained in section 115VT or section 115VU or section 115VV.

(4) The tonnage tax option will also cease to have effect in case –

(i) a company is excluded from the tonnage tax scheme under section 115VZC or

(ii) the qualifying company furnishes to the Assessing Officer, a declaration in writing to the effect that the provisions of this Chapter may not be made applicable to it.

(5) In such a case, the profits of the company from the business of operating qualifying ships shall be computed in accordance with the other provisions of the Income-tax Act.

Renewal of tonnage tax scheme [Section 115VR]

(1) An option for tonnage tax scheme approved under section 115VP may be renewed within one year from the end of the previous year in which the option ceases to have effect.

(2) The provisions of sections 115VP and 115VQ discussed above would apply in relation to a renewal of the option for tonnage tax scheme in the same manner as they apply in relation to the approval of option for tonnage tax scheme.

Bar from opting for tonnage tax scheme in certain cases [Section 115VS]

(1) A qualifying company is not eligible to opt for the tonnage tax scheme if –

(i) the company, on its own, opts out of the tonnage tax scheme or

(ii) it makes a default in complying with the provisions of section 115VT or section 115VU or section 115VV or

(iii) its option has been excluded from tonnage tax scheme in pursuance of an order made under section 115VZC(1).

(2) In such cases, the qualifying company will not be eligible to opt for tonnage tax scheme for a period of ten years from the date of such opting out or default or order, as the case may be.

(3) CONDITIONS FOR APPLICABILITY OF TONNAGE TAX SCHEME

Transfer of profits to Tonnage Tax Reserve Account [Section 115VT]

(1) A tonnage tax company is required to credit to a reserve account (called Tonnage Tax Reserve Account) an amount not less than twenty per cent of the book profits derived from its core and incidental activities (referred to in section 115V-I(1)) in each previous year to be utilised in the manner laid down below –

(i) The amount credited should be utilized for acquiring a new ship before the expiry of 8 years for the purposes of the business of the company; and

(ii) Until the acquisition of a new ship, the amount can be utilized for the purposes of the business of operating qualifying ships other than for distribution by way of dividends or profits or for remittance outside India as profits or for the creation of any asset outside India. [Sub-section (3)]

(2) A tonnage tax company may transfer a sum in excess of twenty per cent of the book profits. Such excess sum transferred should also be utilised in above manner.

(3) "Book profit" will have the same meaning as in the Explanation to section 115JB(2) so far as it relates to income derived from the core and incidental activities.

(4) Where the company has book profit from the business of operating qualifying ships and book loss from any other source, and consequently, the company is not in a position to create the full or any part of the reserves as required, then –

(a) the company should create the reserves to the extent possible in that previous year.

(b) The shortfall, if any, will be added to the amount of the reserves required to be created for the following previous year.

(c) Such shortfall will be deemed to be part of the reserve requirement of that following previous year.

(5) **Consequences of misutilisation / non-utilisation [Sub-section (4)]**

(i) Where any amount credited to the Tonnage Tax Reserve Account has –

(a) been utilized for any purpose other than that referred to in (1) above; or

(b) not been utilized for the purpose of acquiring a new ship for the purpose of the business of the company within 8 years; or

(c) has been utilized for acquiring a new ship within 8 years but such ship is sold or transferred, otherwise than in any scheme of demerger, within 3 years from the end of the previous year in which it was acquired

then, an amount which bears the same proportion to the total relevant shipping income of the year in which such reserve was created, as the amount out of such reserve so utilized or not utilized bears to the total reserve created during that year shall be taxable under the other provisions of the Act i.e.

$$\text{Taxable amount} = \text{Relevant shipping income} \times \frac{\text{Extent of reserves unutilized or misutilised}}{\text{Total reserve created during the year}}$$

(ii) Such amount as calculated above would be taxable -

(a) in case (a) of (i) above, in the year in which the amount was so utilized; or

(b) in case (b) of (i) above, in the year immediately following the period of 8 years;

(c) in case (c) of (i) above, in the year in which the sale or transfer took place.

(iii) However, the income so taxable under the other provisions of the Act will be reduced by the proportionate tonnage income charged to tax in the year of creation of such reserves.

(6) **Shortfall in credit to Tonnage Tax Reserve Account [Sub-section (5)]**

If there is any shortfall in the amount credited to the Tonnage Tax Reserve Account, then the amount which bears the same proportion to the total relevant shipping income as the shortfall in credit to the reserves bears to the minimum reserve required to be credited, will be taxable under the other provisions of the Act i.e.

$$\text{Taxable amount} = \text{Relevant shipping income} \times \frac{\text{Shortfall in credit to reserves}}{\text{Minimum reserve to be credited}}$$

(7) **Consequences of failure to create reserve for two consecutive previous years [Sub-section (6)] -**

If the reserve required to be created is not created for any two consecutive previous years, the option of the company for tonnage tax scheme will cease to have effect from the beginning of the previous year following the second consecutive previous year in which the failure to create the reserve had occurred.

(8) **Meaning of "new ship"**

A new ship includes a 'qualifying ship', which before the date of its acquisition by the qualifying company was used by any other person. However, it should not have been owned by any person resident in India before the date of such acquisition.

Minimum training requirement for a tonnage tax company [Section 115VU]

(1) A tonnage tax company, after its option has been approved under section 115VP(3) is required to comply with the minimum training requirement in respect of trainee officers in accordance with the guidelines framed by the Director-General of Shipping and notified in the Official Gazette by the Central Government. [Sub-section (1)]

(2) A copy of the certificate issued by the Director-General of Shipping to the effect that such company has complied with the minimum training requirement in accordance with the guidelines referred to in sub-section (1) for the previous year is required to be furnished along with the return of income.

(3) If the minimum training requirement is not complied with for any five consecutive previous years, the option of the company for tonnage tax scheme shall cease to have effect from the start of the previous year following the fifth consecutive year in which the failure to comply with the minimum training requirement occurred.

Limit for charter in of tonnage [Section 115VV]

(1) Every company which has opted for tonnage tax scheme should charter in not more than forty nine per cent of the net tonnage of the qualifying ships operated by it during any previous year. The term "chartered in" does not include a ship chartered in by the company on bareboat charter-cum-demise terms.

(2) Such proportion of net tonnage in respect of a previous year is to be calculated based on the average of net tonnage during that previous year.

(3) The average of net tonnage is to be computed in such manner as may be prescribed in consultation with the Director-General of Shipping.

(4) Where the net tonnage of ships chartered in exceeds the limit of 49% during any previous year, the total income of such company in relation to that previous year is to be computed as if the option for tonnage tax scheme does not have effect for that previous year.

(5) Where the said limit of 49% is exceeded in any two consecutive previous years, the option for tonnage tax scheme shall cease to have effect from the beginning of the previous year following the second consecutive previous year in which the limit had exceeded.

Maintenance and audit of accounts [Section 115VW]

An option for tonnage tax scheme by a tonnage tax company will not have effect in relation to a previous year unless such company –

(i) maintains separate books of account in respect of the business of operating qualifying ships and

(ii) furnishes, along with the return of income for that previous year, the report of an accountant, in the prescribed form duly signed and verified by such accountant.

The Explanation to the section provides that an "Accountant" shall have the same meaning as in the Explanation below section 288(2).

Determination of tonnage [Section 115VX]

(1) The tonnage of the ship shall be determined in accordance with the valid certificate indicating its net tonnage.

(2) "Valid certificate" means –

(i) in case of ships registered in India—

(a) having a length of less than twenty-four metres, a certificate issued under the Merchant Shipping (Tonnage Measurement of Ship) Rules, 1987 made under the Merchant Shipping Act, 1958;

(b) having a length of twenty-four metres or more, an international tonnage certificate issued under the provisions of the Convention on Tonnage Measurement of Ships, 1969 as specified in the Merchant Shipping (Tonnage Measurement of Ship) Rules, 1987 made under the Merchant Shipping Act, 1958;

(ii) in case of ships registered outside India,

(a) a licence issued by the Director-General of Shipping under section 406 or section 407 of the Merchant Shipping Act, 1958 specifying the net tonnage on the basis of Tonnage Certificate issued by the Flag State Administration where the ship is registered or

(b) any other evidence acceptable to the Director-General of Shipping produced by the ship owner while seeking permission for chartering in the ship.

(4) AMALGAMATION AND DEMERGER OF SHIPPING COMPANIES

Amalgamation [Section 115VY]

(1) In case of amalgamation, the provisions relating to the tonnage tax scheme would apply to the amalgamated company if it is a qualifying company.

(2) However, where the amalgamated company is not a tonnage tax company, it should exercise an option for tonnage tax scheme under section 115VP(1) within three months from the date of the approval of the scheme of amalgamation.

(3) Where the amalgamating companies are tonnage tax companies, the provisions of this Chapter would apply to the amalgamated company for such period as the option for tonnage tax scheme which has the longest unexpired period continues to be in force.

For example, if two tonnage tax companies X Ltd. and Y Ltd. are amalgamated to form a new company Z Ltd., and the option for tonnage tax scheme of X Ltd. has an unexpired period of 8 years and Y Ltd. has an unexpired period of 6 years, then the provisions of this Chapter would apply to the new company Z Ltd. for a period of 8 years.

(4) Where one of the amalgamating companies is a qualifying company on 1st October, 2004 and has not exercised option for tonnage tax scheme within the initial period, then –

(i) the provisions of this Chapter will not apply to the amalgamated company and

(ii) the income of the amalgamated company from the business of operating qualifying ships has to be computed in accordance with the other provisions of the Act.

Demerger [Section 115VZ]

(1) Where in a scheme of demerger, the demerged company transfers its business to the resulting company before the expiry of the option for tonnage tax scheme, then the scheme would apply to the resulting company for the unexpired period if it is a qualifying company.

(2) The option for tonnage tax scheme in respect of the demerged company would remain in force for the unexpired period of the tonnage tax scheme if it continues to be a qualifying company.

(5) OTHER PROVISIONS

Effect of temporarily ceasing to operate qualifying ships [Section 115VZA]

(1) A temporary cessation (as against permanent cessation) of operating any qualifying ship by a company would not be considered as a cessation of operating of such qualifying ship. The company would still be deemed to be operating such qualifying ship for the purposes of this Chapter.

(2) Where a qualifying company continues to operate a ship, which temporarily ceases to be a qualifying ship, then such ship will not be considered as a qualifying ship for the purposes of this Chapter.

(6) CASES WHERE PROVISIONS OF THIS CHAPTER DOES NOT APPLY

Avoidance of tax [Section 115VZB]

(1) The tonnage tax scheme will not apply where a tonnage tax company is a party to any transaction or arrangement which amounts to an abuse of the tonnage tax scheme.

(2) A transaction or arrangement will be considered as an abuse if the entering into or the application of such transaction or arrangement results, or would, but for this section have resulted, in a tax advantage being obtained by –

(a) a person other than a tonnage tax company; or

(b) a tonnage tax company in respect of its non-tonnage tax activities.

(3) "Tax advantage" includes,—

(i) (a) the determination of the allowance for any expense or interest, or

(b) the determination of any cost or expense allocated or apportioned,

which has the effect of reducing the income or increasing the loss, as the case may be, from activities other than tonnage tax activities chargeable to tax.

Such computation should be on the basis of entries made in the books of account in respect of the previous year in which the transaction was entered into; or

(ii) a transaction or arrangement which produces to the tonnage tax company more than ordinary profits which might be expected to arise from tonnage tax activities.

Exclusion from tonnage tax scheme [Section 115VZC]

(1) Where a tonnage tax company is a party to any transaction or arrangement which amounts to an abuse of the tonnage tax scheme, the Assessing Officer has the power to exclude such company from the tonnage tax scheme, by an order in writing, after giving an opportunity of being heard to such company.

(2) However, no order to this effect can be passed without the previous approval of the Chief Commissioner.

(3) This section does not apply where the company shows to the satisfaction of the Assessing Officer that the transaction or arrangement was a bona fide commercial transaction and has not been entered into for the purpose of obtaining tax advantage under this Chapter.

Where an order has been passed by the assessing officer excluding the tonnage tax company from the tonnage tax scheme, then, the option for tonnage tax scheme shall cease to be in force from the first day of the previous year in which the transaction or arrangement was entered into.

13.70 Income Tax

13.6 ASSESSMENT OF CO-OPERATIVE SOCIETIES

13.6.1 General Provisions: The expression "co-operative society" means a society registered under the Cooperative Societies Act, 1912 or under any other law for the time being in force in any State for the registration of co-operative societies [section 2(19)]. For purposes of taxation, it is treated as a separate assessable entity. The profits of any business of insurance carried on by a co-operative society are to be computed in accordance with the rules set out in the First Schedule to the Act. Apart from this, the computation of income in the case of a co-operative society should also be made in the same way under each head of income as in the case of any other assessee. Entrance fees received by a co-operative society from its members is taxable as its income from business irrespective of the nature of the business carried on by the society as was held in *Co-operative Central Bank vs. C.I.T. (1965). 57 I.T.R. 579.*

A member of a co-operative society to whom a building or a part thereof is allotted or leased under a house building scheme of the society must be deemed to be the owner of that building or part thereof under section 27(iii). Accordingly, the co-operative society is not liable to pay tax in respect of the income from the house property even though it may be the real owner according to official records and the tenant may have taken the building on lease. But where the tenant is not a member of the society or where the house is allotted to him otherwise than under a house building scheme of the society, the society will be liable to tax in respect of the income of the house property.

13.6.2 Exemptions : 1. The income of a marketing society derived from the letting out of godown or warehouses for storage, processing or facilitating the marketing of commodities is totally exempt from tax under section 10(29).

2. Section 80P provides certain exemptions to co-operative societies. However, the exemption is not available to co-operative banks, other than primary agricultural credit societies and primary co-operative agricultural and rural development banks. Students may refer to the detailed discussion of this provision in Chapter 12 "Deductions from gross total income".

It may also be noted that the provisions of section 194A which require deduction of income-tax at source from interest other than interest on securities, credited or paid, where the aggregate payment in any financial year exceeds Rs.5,000 do not apply to such income credited or paid –

(i) by a co-operative society to a member thereof or to any other co-operative society;

(ii) in respect of deposits with a primary agricultural credit society or a primary credit society or a co-operative land mortgage bank or a co-operative land development bank;

(iii) in respect of deposits with a co-operative society, other than a co-operative society or bank engaged in carrying on the business of banking.

13.7 ASSESSMENT OF MUTUAL CONCERNS

13.7.1 General principles of mutuality: (1) The first principle of mutuality is that no person can trade with himself or make income out of himself. A mutual association arises where persons forming a group associate together with a common object and contribute monies for achieving that object and divide the surplus amongst themselves in the character. The cardinal requirement in the case of mutual association is that all the contributors to the common fund must be entitled to participate in the surplus and all the participators to the surplus must be contributors to the common fund. In other words, there must be complete identity between the contributors and the participators.

(2) The participation in the surplus need not be immediate but it may assume the shape of a reduction in the future contribution or a division of the surplus on dissolution.

(3) It does not make any difference whether the persons joining together form an association or incorporate a company because the fact of incorporation does not destroy the identity of the contributors and participators.

(4) Where there is mutuality, the fact that some members alone take advantage of the mutual enterprise would not affect the mutual character of the association.

(5) There is nothing in law which prohibits a mutual association from carrying on a trade so long as it is confined to its own members.

(6) It is not necessary that the surplus should be returned to every member of the association pro rata. The identification between the contributors and the participators should be regarded as one whole and not in relation to each individual.

(7) It is not necessary that all the activities of such an association should be mutual in character. There may be activities of a non-mutual character but the exemption from tax will apply to the surplus arising out of the mutual enterprise.

From the above principles we can conclude that one cannot trade with one self and earn taxable profits thereby. Hence if there is a mutual concern, ordinarily there should be no tax on the profits arising out of mutual operations. But the Income-tax Act, 1961 provides for assessment of the income of a mutual concern in the following circumstances:

(1) Where the mutual concern is a mutual insurance society and the income is derived from the carrying on of any business of insurance.

(2) Where the mutual concern is a trade, professional or similar association and the income in question is derived from specific service performed for its members.

13.7.2 Insurance business: Under section 2(24)(vii) any surplus accruing to life as well as general mutual insurance concerns will fall within the definition of the word “income” and as such would be taxable as income from business, section 44 expressly provides the profits and gains of any business of insurance including that carried on by a mutual

insurance company or a cooperative society shall be computed not according to the provisions of the Act for computation of income under the various heads but according to the method prescribed in the Rules contained in the First Schedule to the Act.

13.7.3 Trade and professional associations: A trade, professional or similar association may be a mutual concern. Section 28(iii) enacts that "income derived by a trade, professional or similar association from specific services performed for its members" shall be taxable as business profits. Under section 2(24)(v) any sum chargeable under section 28(iii) is deemed to be income. The object of these provisions seems to be to tax as profit the surplus arising from specific services rendered to members by a mutual trade, professional or similar association which otherwise may not be liable to tax in view of the general principles applicable to mutual concerns.

It may carefully be noted that a trade association is not the same thing as a trading association. A trade association means an association of tradesmen or businessmen for the protection or advancement of their common interests. Again clause (iii) of section 28 taxes the profit accruing only on specific services rendered by an association to its members. Any surplus arising to a mutual association in other way e.g. from entrance fees or members' periodic subscriptions would be outside the scope of this clause and would be non-taxable on the general principles stated above.

Since the surplus arising to trade, professional or similar association during the process of advancement of the common interest of the members is not includible in the taxable income it follows that the concerned expenditure will not also be allowed. Section 44A gives a benefit in this regard. It provides that in the case of such trade associations which did not distribute any parts of its income to its members, the amount of any deficit (deficiency) (excess of expenditure incurred for the advancement of the common interest of the members of the association over receipt from the members) would be deductible from the assessable income of the association to the maximum extent of 50% of such income.

This deficiency is to be deducted in the first instance from the assessable income under the head "Profits and gains of business or profession". If the deficiency exceeds such income the balance of deficiency can be set off against assessable income from any other head. The maximum limit of 50%, however, still operates. It can be carried forward to the next year and set-off against income of the relevant assessment year. It should be noted that any adjustment of the deficiency is permissible only after effect has been given as provided in the Act to all losses, allowances etc., for the year in question or brought forward from earlier years.

13.7.4 Clubs: The consensus of judicial opinion is that any surplus accruing to a members' club from the subscriptions and charges for various conveniences paid by members is not income or profit at all, nor can a social club be deemed to trade as far as its dealings with its own members are concerned. The position would be the same even

though the club may be incorporated as a company or registered as a society. But a club is taxable on the profit derived from subscriptions and charges paid by non-members and on the income derived from its capital assets. Where a club is an incorporated company carrying on business it may be taxable on the money received from its members as well as non-members in the course of its business.

However, if the club is not a member's club but is a proprietary club i.e. if the club is owned by an outsider and not by the members themselves, the proprietor would be taxable on the profits earned by running the club. The position would not in any way be affected by the fact that the proprietor is a limited company and some of the shareholders are members of the club.

13.7.5 Co-operative societies: In the case of a co-operative society, the liability to tax depends upon whether (a) it is a mutual concern earning non-taxable surplus or (b) it is a non-mutual concern earning taxable profits. Exemption under section 80P is available to co-operative societies. However, this benefit is not available to co-operative banks, other than primary agricultural credit societies and primary co-operative agricultural and rural development banks. The definition of income has been enlarged to include within its scope, the profits and gains of any business of banking (including providing credit facilities) carried on by a co-operative society with its members. Therefore, the concept of mutuality no longer applies to a co-operative society carrying on any business of banking.

13.8 LIABILITY IN SPECIAL CASES

13.8.1 Legal representatives [Section 159]:

- **Meaning:** Section 2(19) states that the term "legal representative'' in the Income-tax Act has the meaning assigned to it in clause (II) of section 2 of the Code of Civil Procedure, 1908. Section 2(11) of the Code of Civil Procedure provides as follows:

  "Legal representative" means a person who in law represents the estate of a deceased person and includes any person who intermediates with the estate of the deceased and where a party sues or is sued in a representative character the person on whom the estate devolves on the death of the party so suing or sued. It is not necessary that the legal representative should be the beneficial owner of the estate. Nor need he be in possession of any property of the deceased. It is sufficient that the estate devolves on him. So far as HUF is concerned it continues to exist as an assessable unit despite change in its composition including the change of its Karta by death or otherwise and consequently there is no scope or necessity for involving this section when a Karta dies. A legal representative assessed under this section is different from a representative assessee to whom sections 160 to 167 apply. Legal representative does not fall within any of the categories of representative assessee

enumerated in section 160. Where a person leaves a will appointing executors, the executors are the legal representative. The Act expressly declares that the legal representative is deemed to be an assessee for the purpose of this Act.

- **Liability of legal representative:** The Act imposes a liability on the legal representative not only in respect of tax but also any other sum (penalty, fine or interest) which the deceased would have been liable to pay if he had not died. This liability is limited to the extent to which the estate is capable of meeting the liability.
- **Assessment on legal representative:** This section applies irrespective of whether the assessment proceedings has not been started, or were pending, or were completed and the assessment made, before the death of the deceased. If at the date of death of the deceased a return of income had not been made under section 139(1) and a notice under section 139(2) or section 148, as the case may be, had not been served on him, the Assessing Officer should first issue the notice under appropriate section to the legal representative of the deceased and then proceed to assess the income of the deceased in the hands of the representative as if the representative were the assessee. If there are more legal representatives than one, the notice should be served on all of them; but it would be sufficient if the notice is served on one or more who effectively represent the estate or who are ascertained, after diligent and bonafide inquiry by the Assessing Officer to be the legal representatives. It is obligatory upon the representative to comply with the notices appropriately served. Assessment may be made on the representative under section 147 in respect of income of the deceased which had escaped assessment in the relevant years.
- **Income upto the date of death and the end of the accounting year:** Students should carefully note that section 159 applies in respect of the income of the deceased only upto the date of death and not upto the end of the accounting year in which the death occurs. The income of the estate for the period from the date of death upto the end of the accounting year in which the death occurs should be assessed under section 168 in the hands of the executor. Thus in respect of the year of death two separate and distinct assessments would have to be made, the prior one on the legal representative and the latter one on the 'executors' under section 168. This may even lower the incidence of tax for the year. The position will be the same even if the representative and the 'executor' are one and the same.
- **Apportionment:** As a consequence of two separate assessments as mentioned above apportionment of income between the two periods becomes necessary. Here it is to be noted that certain incomes like dividends or interest if they become payable after the death cannot be apportioned to the period upto the date of death because they do not accrue from day to day.

- **Penalty on legal representative:** Penalty proceedings for a default committed by the deceased can be started or continued against the legal representative. He, being an assessee, is also liable to a penalty for his own default.

  Personal liability: We have noted that the liability of a legal representative is "limited to the extent to which the estate is capable of meeting the liability". However, he becomes personally liable to the extent of the value of any asset of the estate which he disposes off while the liability for tax remains undischarged. This personal liability is imposed by sub-section (4) only in respect of tax and not in respect of penalty, fine or interest.

- **Recovery from legal representative:** A legal representative must be regarded as an assessee for the purposes of recovery proceedings. A recovery certificate issued to the tax recovery officer during the life-time of the assessee may, after his death, be enforced against his legal representative without the name of the latter being substituted in the certificate. But such proceeding cannot be started against him unless he has been served with a notice of demand under section 156. Further he is not personally liable for the tax payable by the deceased unless some assets of the deceased have come into his hands and are not properly applied or accounted for.

13.8.2 Representative assessee [Section 160]:

- **General :** Besides the legal representatives mentioned above, in certain cases, the income received by one person can be assessed in the hands of another. Persons who are liable to be assessed on behalf of other because of their association with the real recipient of the income are known as representative assessees. The expression 'representative assessee' means:

  (i) the agent of a non-resident including a person who is treated as an agent under section 163 in respect of the income of the non- resident which is deemed to accrue or arise to him in India;

  (ii) the guardian or a manager of a minor, a lunatic or an idiot in respect of the income of such latter person;

  (iii) the Court of Wards, Administrator-General, Official Trustee, Receiver or Manager appointed by or under any order of a Court in respect of the income which they received or are entitled to receive on behalf of or for the benefit of any person; and

  (iv) a trustee appointed under a trust deed by a duly executed instrument in writing, whether, testamentary or otherwise, in respect of any income which he is entitled to receive on behalf of or for the benefit of any person;

  (v) a trustee appointed under an oral trust in respect of the income which he receives or is entitled to receive on behalf of or for the benefit of any person.

The explanation added for the purpose of the last category makes it clear that a trust which is not declared by a duly executed instrument in writing (including a Wakf deed which is valid under the Mussalman Wakf Validating Act, 1913) will be deemed to be a trust declared by a duly executed instrument in writing if a statement in writing signed by the trustee or trustees and setting out the purpose or purposes of the trust, particulars of the trustee or trustees, the beneficiary or beneficiaries and the trust property, is prepared and forwarded to the Assessing Officer within the specified time limit. The specified time-limit will be three months from date of the declaration of the trust. For this purpose, the item 'oral trust' means a trust which is not declared by a duly executed instrument in writing including any Wakf deed and which is also not deemed under the new explanation I to be a trust declared by a duly executed instrument in writing.

- **Liability of a representative assessee [Section 161]:** Every representative assessee is deemed to be an assessee under the Income-tax Act. He therefore, has the same responsibilities, duties and liabilities as if the income were being received by him beneficially. He is liable to be assessed in his own name in respect of such income but the assessment is deemed to have been made upon him in his representative capacity. The tax is levied on and is recovered from such an assessee, in like manner and to the same extent as it would have been levied upon and recovered from the person represented by him.

  Where any income in respect of which the trustee, appointed under a trust declared by a duly executed instrument in writing whether testamentary or otherwise, including any valid wakf deed, is liable as a representative assessee, consists or includes profits and gains of business, tax shall be charged on the whole of the income in respect of such a person at the "maximum marginal rate". However, this provision will not apply in cases where such profits and gains are receivable under a trust declared by any person by will exclusively for the benefit of any relative dependent on him for support and maintenance and such is the only trust so declared by him.

  The department has the option to make an assessment on the representative assessee or a direct assessment on the person beneficially entitled to the income. Thus, the Assessing Officer may assess the agent or the non-resident; he may assess the guardian, manager, receiver or trustee or assess the beneficiary directly. Therefore, if an incapacitated person has no trustee or guardian or, if the trustee or guardian is not resident in India and cannot be found, the assessment may be made on the incapacitated person directly. But once the department has exercised this option and assessed the representative assessee or the beneficial recipient of the income, it cannot again assess the same income to tax in the hands of the other. The department having assessed either of the two, has the option to recover the tax from the property held by him or by the other. This option conferred on the department in the interest of the revenue has to be exercised judiciously and with reasonable care.

  The provisions of sections 160 and 161 contain only a machinery to levy and collect

the tax but do not, in any way, affect the incidence of tax on a certain income and the scope of total income that must be subjected to tax.

- **Right of a representative assessee to recover tax paid [Section 162]**: Every representative assessee who is charged to tax as such is entitled to recover the tax paid from the person on whose behalf he had paid it or to adjust it against any moneys in his possession, but belonging to the other persons. The representative assessee has the right to retain out of the moneys in his representative capacity, an amount equal to any sum paid or payable by him under the Act in addition to the right to recover the same from the beneficial owner of the income. An agent who apprehends that he may be assessed as a representative assessee has the right to retain such sum irrespective of the fact that the non-resident may turn out to be not at all assessable to tax in India when the assessment is ultimately made upon him.
- **Statutory agent of non-residents:** An agent is considered a representative assessee but only if he is the agent of non- resident person. According to section 163, an agent, in relation to a non-resident person, includes any person in India:
  - (i) who is employed by or on behalf of the non-resident;
  - (ii) who is having any business connection with the non-resident;
  - (iii) from or through whom the non-resident is in receipt of any income, whether directly or indirectly;
  - (iv) who is trustee of the non-resident; and
  - (v) any other person who (whether resident or non-resident) has acquired a capital asset in India by means of a transfer from the non-resident.

In the first four cases stated above, the person sought to be assessed as the agent of a non-resident must necessarily be in India whereas it need not be so in the fifth case. Thus, a non-resident may be treated as the agent of another non-resident. The appointment of the agent may be made any time before or after the expiry of the relevant previous year. An agent of a non- resident may be appointed under this section even if at the date of such appointment the non-resident is not alive.

According to the proviso to this section, where transactions are carried on in the ordinary course of business through a broker in India and the broker does not deal directly with or on behalf of a non-resident principal but deals with or through a non-resident broker the broker in India cannot be treated as statutory agent in respect of the income arising to the non-resident from such transactions. Thus, where bona fide hedging transactions take place through a broker in India and a foreign broker acting for an undisclosed principal, the Indian broker cannot be deemed to be agent of the foreign principal. But generally a broker is not deemed to be the agent of a non-resident person so long as he functions exclusively in his capacity as a broker.

13.78 Income Tax

For the purposes of section 163(1), the expression “business connection” shall have the meaning assigned to it in Explanation 2 to clause(i) of section 9(1) of the Income-tax Act, 1961.

Before a person can be treated as an agent of a non-resident he must be given a reasonable opportunity of being heard by the Assessing Officer as to his liability to be so treated.

The agent is chargeable to tax in India as a representative assessee only in respect of the income which is deemed to accrue or arise in India to the non-resident under section 9(a)(i). [This has been discussed in Chapter 2]. He is a chargeable to tax in the like manner and to the same extent as the non-resident and is assessable in respect of the income of the non-resident only. The agent for being assessed under this section need not be in receipt of the income on behalf of the non-resident in respect of which he is assessed. Thus, a person in India who has not received any income on behalf of a non-resident but has actually paid the non-resident the sums sought to be taxed (i.e., interest on a loan advanced by the non-resident or dividends) may be treated as an agent under this section. The agent’s liability is personal and, therefore, cannot be negotiated; this liability is not also conditional to take effect upon his having funds of the non-resident. If the agent is not able to recover from the non- resident the amount of tax, he cannot claim it as a bad debt or a loss or an expense incidental to the business. There is no provision in the Act for recovering the tax from his personal assets, where the assessment is made directly on the non-resident’s agent though the department is entitled to proceed against the non- resident’s property in the possession of the agent.

13.8.3 Taxation of Discretionary Trusts [Section 164(1)]: Section 164 deals with taxation of trustees of discretionary trusts. This section applies in the case of a representative assessee referred to in clause (iii) or clause (iv) of sub-section (1) of section 160 in a case where any income or part thereof is not specifically receivable on behalf of or for the benefit of any one person or where the individual shares of the persons on whose behalf or for whose benefit such income or such part thereof is receivable are indeterminate or unknown.

The representative assessees referred to in clauses (iii) and (iv) of section 160(1) are the Court of Wards, the Administrator General, the Official Trustee or any receiver or manager including any person whatever his designation who in fact manages the property on behalf of another, appointed by or under any order of a Court and a trustee appointed under a trust declared by a duly executed instrument in writing whether testamentary or otherwise (including any Wakf Validating Act, 1913).

Such a discretionary trust will be liable to tax at the maximum marginal rate of income-tax on their entire income.

With a view to obviating hardship in genuine cases where the circumstances are such that

tax evasion could not be considered to be main purpose of creating a trust, certain exceptions have been specified where the trust would not be taxed at the maximum marginal rate. The exceptions are as under:

(1) Where none of the beneficiaries has any other income chargeable to tax or is a beneficiary under any other trust. In this context, the expression, "income chargeable to tax" would mean total income above the exemption limit for the relevant assessment year. Thus the income of a discretionary trust will be chargeable to tax at the maximum marginal rate in cases where any of the beneficiaries has any other taxable income exceeding the exemption limit or if any of the beneficiaries is a beneficiary under any other trust.

(2) Where the discretionary trust is created under a will and such trust is the only trust so created under the will.

(3) In case of a discretionary trust created prior to 1.3.1970 by a non-testamentary instrument if the Assessing Officer is satisfied that the trust was so created bona fide exclusively for benefit of the dependent relatives of settlor or where the settlor is a H.U.F. for the benefit of the members of such families in circumstances where such relatives or members are mainly dependent on the settlor for their support and maintenance.

(4) In cases where the income is receivable by the trustee on behalf of provident fund, superannuation fund, gratuity fund, pension fund or any other fund created bona fide by a person carrying on a business or profession exclusively for the benefit of persons employed in such business or professions.

In the above four cases the income of the trustees will be taxed not at the marginal rate but at the rate applicable to the income of an association of persons.

Where any income in respect of which a trustee appointed under a trust declared by a duly executed instrument in writing whether testamentary or otherwise, is liable as a representative assessee consists of or includes profits and gains of business, the above concessional treatment i.e. assessing the income at the rate applicable to an AOP will apply only if such profits and gains are receivable under a trust declared by any person by will exclusively for the benefit of any relative dependent on him for support and maintenance and such trust is the only trust so declared by him.

For the purposes of these provisions a trust under which a discretionary power is given to the trustees to decide the allocation of the income every year or a right is given to the beneficiary to exercise the option to receive the income or not each year will all be regarded as discretionary trusts and assessed accordingly. This is made clear in *Explanation 1* to section 164 which provides as under.

(a) Any income in respect of which the Court of Wards, the Administrator General, the

Official Trustee, receiver, manager, trustee or mutawalli appointed under a Wakf deed is liable as a representative assessee or any part thereof shall be regarded as not being specifically receivable on behalf or for the benefit of any person unless the person on whose behalf or for whose benefit such income or such part thereof is receivable during the previous year is expressly stated in the order of the Court or the instruments of trust or wakf deed, as the case may be, and is identifiable as such on the date of such order, instrument or deed. For this purpose, it is not necessary that the beneficiary in the relevant previous year should be actually named in the order of the Court or the instrument of trust or wakf deed, all that is necessary is that the beneficiary should be identifiable with reference to the order of the Court or the instrument of trust or wakf deed on the date of such order instrument or deed.

(b) The individual shares of the person on whose behalf or for whose benefit such income or part thereof is receivable will be regarded as indeterminate or unknown unless the individual shares of such persons are expressly stated in the order of the court or the instrument of trust or wakf deed, as the case may be, and are ascertainable as such on the date of such order, instrument or deed.

This explanation seeks to prevent trustees and beneficiaries from manipulating the arrangements in such a manager that a discretionary trust is converted into a specific trust whenever it suits them tax-wise.

- **Income from property held under wholly for charitable or religious purposes [Section 164(2)]:** In case the income, in respect of which the shares of the beneficiaries are indeterminate or unknown, is derived from property held under trust wholly for charitable or religious purpose or which is of the nature referred to in section 2(24)(iia) (voluntary contributions received by a trust) or which is of the nature referred to in sub-section (4A) of section 11 (business income received by a trust), the tax shall be charged on so much of the income as is not exempt under section 11 or 12 as if the income not so exempt were the income of an association of persons.

  Where the whole or any part of the relevant income is not exempt under section 11 or section 12 because any income thereof is for the benefit of prohibited persons or the rules with regard to investments in specified channels have not been followed, tax shall be charged on the relevant income or part of relevant income at the maximum marginal rate.

- **Income from property held under trust partly for religious purposes and partly for other purposes [Section 164(3)]:** If property held under trust partly for religious purposes and partly for other purposes and the individual share of the beneficiaries in the income applicable to purposes other than charitable purposes is not known, tax liability will be the aggregate of the following:

(a) the tax which would be chargeable on that part of the relevant income which is applicable to charitable or religious purposes (as reduced by the income, if any, which is exempt under section 11 as if such part (or such part so reduced) were the total income of the association of persons; and

(b) the tax on that part of income which is applicable to purposes other than charitable or religious and in respect of which shares of beneficiaries are indeterminate or unknown, at the maximum marginal rate.

However, in the following cases, income will be charged to tax as if it were income of an association of persons:

(a) where none of the beneficiaries has any other income chargeable to tax i.e. income should not exceed the maximum amount not chargeable to income-tax and none of the beneficiaries is a beneficiary under any other private trust; or

(b) where the trust is created by will and such trust is the only trust so declared by him; and

(c) where the trust is a non-testamentary one created before March 1, 1970 for the exclusive benefit (to the extent it is not utilised for charitable or religious purposes) or relatives of the settler mainly dependent on the settler for their support or maintenance or where settler is a Hindu undivided family, for the exclusive benefit of its members so dependent upon it.

(1) Where the relevant income consists of or includes profits and gains of business, the preceding concessional method of taxation shall apply only if the income is receivable under a trust declared by any person by will exclusively for the benefit of any relative dependent on him for support and maintenance and such trust is the only trust so declared by him.

(2) Where the whole or any part of the relevant income is not exempt under section 11 or section 12 because any income thereof enures to the benefit of prohibited persons or the rules with regard to investment in specified channels have not been followed, tax shall be charged on the relevant income or part of relevant income at the maximum marginal rate.

- **Taxation of Oral Trusts [Section 164A]:** Under this provision, any income which a trustee receives or is entitled to receive on behalf of or for the benefit of any person under an oral trust will be chargeable to income tax at the maximum marginal rate. For this purpose the expression “maximum marginal rate” is the rate of income-tax including surcharge of income-tax applicable in relation to the highest slab of income in the case of an association of persons as specified in the Finance Act of the relevant year. As a result of this provision an oral trust, the terms whereof are not subsequently recorded in writing and intimated to the Assessing Officer in the

specified manner, will be chargeable to income-tax at the maximum marginal rate in all cases. However, if the terms of an oral trust are subsequently recorded in writing and intimated to the Assessing Officer in the specified manner the income will be chargeable to tax at the maximum marginal rate only in those cases where the shares of the beneficiaries are indeterminate and unknown. Where, however, such shares are determinate or known the tax will be levied and recovered from the trustees in the same manner and to the same extent as would be leviable or recoverable from the beneficiaries.

- **Case where part of trust income is chargeable:** Section 165 provides that in cases where only same portion of the trust income to which the beneficiary or beneficiaries is/are entitled is taxable and the other portion is not taxable the taxable portion of the income received by him from the trust as a beneficiary shall be only such portion thereof as bears to the whole income of the trust. In other words, where a part only of the trust income is chargeable to tax under this Act, the beneficiaries' share of the income should be taken to be that derived proportionately from the chargeable and non-chargeable portions of the trust income and should be assessed accordingly in the hands of trustee/s.

  It may be worthwhile to mention here that every representative assessee is regarded in law as an assessee for all the purposes of the Income-tax Act and is subject to the same duties, responsibilities and liabilities, as if the income were received by or accruing to or in favour of him beneficially and is thus liable to assessment in his own name in respect of the income. It has also been specifically provided that a representative assessee shall not be assessed under any other provisions of the Act in respect of any income relating to which he is representative assessee except in his representative capacity as provided for in section 161 of the Act. A protection has been given to the representative assessee with regard to the recovery of the tax paid by him, if any, on behalf of a beneficiary as regards the income in respect of which he is a representative assessee. Provision has also been made for the representative assessee to obtain a certificate from the Assessing Officer stating the amount which the representative assessee is entitled to retain for the final settlement of the liability.

13.8.4 Executors and Administrators [Sections 168 and 169]: Where executors and administrators or other persons have been appointed to administer the estate of a deceased, the income arising from such an estate shall be chargeable to tax in the hands of the executor or executors, as the case may be. If there is one executor, the assessment shall be made on him in the status of an individual. If on the other hand, there are more executors than one, then the assessment will be made on them in the status of an association of persons. Separate assessment shall be made on the executor or executors on the total income of each completed previous year or part thereof as is included in the period from the date of death of the deceased to the complete distribution

to the beneficiaries of the estate according to their several interests. Any income of the estate of any previous year which is distributed or applied to the benefit of any specific (but not residuary) legatee of the estate during that previous year shall be excluded from the computation of the total income of that previous year assessed in the hands of the executors. The income so excluded shall, however, be included in the total income of the previous year of the 'specific legatee' himself.

Where the executors apply a portion of the income received by them from the estate in a particular way pursuant to the directions of the testator or other legal obligations, it is merely an application of income and would not entitle the executors to claim any deduction in respect of the income so applied. Thus, payment of the cost of the probate, death duties and other debts due to the State or periodic payments to the beneficiaries (other than the specific legatees) property of the testator or to a Court cannot be excluded in computing the executor's chargeable income from the estate.

Under the general law when an executor gives his assent to a specific legatee, the title of the legatee relates back to the date of death and consequently the income arising after the death and before the asset belong to the legatee is taxable in his hands but not as the income of the executor. However, it is only the income distributed to or applied for the benefit of any specific legatee during the previous year which should be excluded from the executors' total income. In other words if the income is not so distributed or applied in the previous year, it would be taxable as part of the income of the executor. If the executor is also the sole beneficiary it does not necessarily follow that he receives the income in the latter capacity.

If the legatee is a residuary legatee, the income from the residue is the income of the executor taxable in his hands so long as the estate has not been completely administered; it is only after the estate is fully administered and the net residue is ascertained that the residuary legatee gets a title and the income, therefore, can be said to accrue to him and can be taxed in his hands. This principle would apply irrespective of the fact whether the residue is settled in trust for a life tenant or is bequeathed absolutely and it would apply even if a part of the income of the estate had been actually paid on account to the residuary legatee pending the administration of the estate. However, the administration may be regarded as completed, the executor's assent to the residuary legacy as valid and the legatee's title as established, although some liabilities due by the estate may remain undischarged.

According to section 169 the rights of the executors for relation and reimbursement or for the recovery of the tax paid by them are the same as those of representative assessees under section 162.

13.8.5 Liability of successor to business in respect of tax chargeable from the predecessor [Section 170]: Where a person carrying on any business, profession, or vocation is succeeded to by another person, both the successor and the person who is

succeeded to (hereinafter called the predecessor) shall be assessed in respect of the actual share to which he is separately entitled in his income, profits and gains of the previous year. Thus, the predecessor in business would be assessable in respect of the income of the year of succession upto the date of succession while the successor would be assessable in respect of the income of that year after the date of succession. Accordingly, the income of the year in which the succession takes place is to be apportioned between the predecessor and the successor with the share of each. The income must be computed separately and each must be granted the deductions and allowance applicable to him. The assessment on each of these persons must be separate and distinct.

However, where the predecessor cannot be found the assessment of the profits of the year on which the succession took place up to the date of succession and also of the one year preceding the year of succession should be made on the predecessor. Again, if the assessment has already been made on the predecessor for either or both of the years aforesaid, but the tax due in pursuance of each assessment cannot be recovered from the predecessor or any person, it shall be entitled to recover the full amount of tax paid by him from the predecessor.

Under this section the Assessing Officer is required to record a finding that the tax in respect of the income of the year of succession or the preceding year cannot be recovered from the predecessor, before seeking to recover such tax from the successor. The successor's liabilities to tax arises also in respect of any gain (e.g., capital gains) accruing to the predecessor from the transfer of the business. The provisions of the section do not apply to cases of succession on the death of the person carrying on a business. The successor, however, is not entitled to claim to carry forward and set off the losses incurred by his predecessor. He has no right to carry forward even the unabsorbed depreciation allowance of the years prior to his succession to the business. The predecessor also cannot carry forward his loss because the right of carry forward can be exercised only if the business in which the loss was incurred is in existence and continues to be carried on by the same person.

13.8.6 Assessment after partition of a H.U.F.[Section 171]: The relevant provisions in this regard have been discussed earlier under the heading "Assessment of a Hindu undivided family".

13.8.7 Shipping business of non-residents [Section 172]: For the assessment of freight earned in India by ships belonging to or chartered by a non-resident, a special mode of assessment is prescribed under the Act. Under this section, no vessel owned by a non-resident can leave any port in India, unless the port authorities grant a tax clearance certificate. Such a certificate shall not be granted unless the master of the vessel produces a certificate from the Income-tax Authorities showing that the taxes payable have been paid or satisfactory arrangements for their payment have been made.

Where the non-resident owner has an agent in India from whom tax is recoverable on a regular assessment, the Assessing Officer in such cases, may grant a port clearance certificate, valid for one year on receipt of an application in his behalf. If the Assessing Officer is not satisfied that there is an agent in India who can be assessed on behalf of non-resident, he shall make a separate assessment in respect of the income of each vessel, before it leaves the port.

In such cases, 7½% of the amount paid or payable in or out of India on account of carriage of passengers or goods to the owner or charterer, is deemed to be his income accruing in India in respect of the carriage. The income of the non-residents from shipping business must be computed under section 44B.

It is the responsibility of the master of the ship to prepare and furnish to the Assessing Officer return of the full amounts paid or payable to the owner or the charterer, on account of the carriage of goods or passengers. On receipt of such a return the Assessing Officer assesses the income and determines the amount of tax payable thereon, at the rates applicable to a company which has not made prescribed arrangement for the declaration and payment of dividends within India. This sum is payable by the master of the ship.

The time limit for completing such assessments is 9 months from the end of the financial year in which the return under section 172(3) is furnished. However, in respect of returns filed on or before 1.4.2007, assessments are required to be completed on or before 31.12.2008.

After the close of the previous year, it is permissible for a non-resident person on whom tax has been charged on an adhoc basis in respect of the income of a vessel to apply along with a return of his income that he may be assessed on the basis of the business income that actually arose to him in the previous year. On completion of the regular assessment the tax paid towards the adhoc assessment shall be adjusted against the amount due from the assessee and the excess or deficiency if any, shall be refunded to or recovered from the non-resident.

13.8.8 Recovery of tax in respect of the income of a non-resident [Section 173]: In the case of the non-resident the tax on the income which is deemed under section (9)(I)(i) to accrue or arise in India and is taxable as such may be recovered - (i) by deduction of tax at source; or (ii) by an assessment on the non-resident directly or (iii) by an assessment on the non-resident's agent in his representative capacity. Any arrears of such tax may also be recovered from any of the assets which may at any time come within India. But the arrears cannot be recovered by filing a suit in the foreign country where the non-resident principal resides since the Courts of one country have no authority to enforce the revenue laws of another.

Generally the proceedings for the recovery of tax cannot be commenced after the expiry of one year from the last day of the financial year in which the demand is made. But section 231 specifically provides that this one year period of limitation does not apply to

recovery of tax under this section from the non-residents' assets in India. This section applies only where the income is covered by section (9)(1)(i); it cannot be made to apply for the recovery of taxes in respect of the income which is not deemed to accrue in India.

13.8.9 Income earned in a financial year assessed in the same financial year - Exceptions to the general rule [Sections 174 to 176]: Generally, the assessment year is always ahead of the previous year. In other words, income which is earned during one financial year is not charged to tax in that very same year but in the next following financial year. To this general rule, there are certain exceptions which are as under:

Persons leaving India [Section 174]: Where it appears to the Assessing Officer that any individual may leave India during the current financial year or shortly after its expiry and that there is no present intention of his returning to India, the Assessing Officer may proceed to assess his total income for the period comprised in the current financial year i.e. the total income of the period from the expiry of the last previous year and if a previous year has already been determined in his case upto the probable date of his departure.

The total income of each completed previous year or part thereof including such period shall be chargeable to tax at the rates in force in that assessment year and separate assessment must be made in respect of each such completed previous year or part thereof. The Assessing Officer is entitled to estimate the income of the individual leaving India for such period or part thereof in cases where his income cannot be readily determined in the manner provided in the Act for the computation of income under each head.

For the purposes of making this assessment the Assessing Officer may serve a notice upon the assessee requiring him to furnish within such time (not being less than seven days) as may be specified in the notice a return, under section 139(2) setting forth his total income for each completed previous year comprised in the period of assessment, and his estimated total income for any part of the period. For all practical purpose this notice issued by the Assessing Officer would not be deemed to be a notice under section 139(2). The tax chargeable on any, individual under the section shall be over and above the tax, if any, chargeable under any other provision of the Act. If an assessee does not furnish the return as required by the notice of the Assessing Officer a best judgment assessment must be made on him under section 144; non-compliance with the requirements of the notice may also attract liability to penalty under section 271.

Assessment under this section may be made even on the income of the period beyond the expiry of the assessment year if the probable date of the assessee's departure is after the expiry of the assessment year. In addition to the issue of notice for making an assessment under this section, the Assessing Officer may as well issue notice under sections 139(2) and 148(1) requiring him to furnish a return and other relevant information within such period being not less than seven days, as he may think fit. Thus, the Assessing Officer is

empowered to make more assessment than one on a person leaving India before his departure from India.

AOP or BOI or Artificial Juridical Person formed for a particular event or purpose [Section 174A]: Section 174A provides for accelerated assessments in cases of certain AOP, BOI etc. If such AOP, BOI etc. is formed or established for a particular event or purpose and the Assessing Officer apprehends that the AOP/BOI is likely to be dissolved in the same year or in the next year, the Assessing Officer can make assessment of the income upto the date of dissolution as income of the relevant assessment year. The provision is on the same basis as contained in section 174 which deals with accelerated assessment of persons leaving India.

Persons trying to alienate their assets [Section 175]: If it appears to the Assessing Officer during any current assessment year that any person is likely to charge, sell, transfer, dispose of or otherwise part with any of his assets with a view to avoiding payment of the whole or any part of his liability under the Income-tax Act, the total income of such person, for the period from the expiry of the previous year for that assessment year to the date when the Assessing Officer commences proceedings under this section shall be chargeable to tax in that assessment year itself. All the provisions of the Act shall apply to such proceeding as they apply in the case of a person leaving India.

Discontinuance of business or profession [Section 176]: Where any business or profession is discontinued in any assessment year, an assessment may be made in that very year of the income from business for the period between the expiry of the previous year relevant to that assessment year and the date of discontinuance, in addition to the assessment, if any, made on the income, profits or gains of the earlier previous year or years. Thus, the Assessing Officer has an option to make a premature assessment of the profits earned up to the date of discontinuance in the year of discontinuance instead of the usual financial year.

The term 'discontinuance' used in this context, refers to complete cessation of the business instead of a mere change of ownership or change in the constitution of firm. A change of ownership may involve succession and, for purpose of this section, a business must be regarded as being continued despite successive changes in its ownership. Since succession and discontinuance are two mutually exclusive concepts there cannot be a discontinuance in cases where there is succession. If a part of the business of an assessee is dropped owing to its non-profitable nature, either permanently or temporarily, it would not imply that the business has been discontinued. In other words, inactivity in trade does not lead to the conclusion that the trade has been discontinued. There may be cases where the trade may be carried on even after the dissolution of the firm or the liquidation of the company. The amalgamation of two separate and independent business belonging to two distinct owners may result in the discontinuance of those business and the change of ownership. Where the business of a joint family or a firm is split up on partition of the family or the dissolution of

the firm and the business is divided into branches or portions amongst the members, it would be a case of discontinuance of the old business even if some or all the members carry on their business in the same premises and take advantages of the old business connections. This is because of the fact that in such a case of the assessee i.e., the family or the firm, has ceased to carry on the business and their is no succession insofar as the integrity of the business is not preserved as was held in *Sait Nagjee Purshotam and Co. Vs. C.I.T. (1964) 51 I.T.R. 489 (S.C.).*

In the case of a profession a firm may discontinue its profession though its patterns may remain in the profession and vice versa. Where a professional man joins a firm, he does not cease to carry on his profession and only when he retires from the firm and ceases to practice once and for all he would be said to have discontinued his profession even though the firm in which he was a partner might continue to function after his retirement with or without new partners. In order to constitute proper discontinuance of the profession for purposes of this section it is not essential that there should be a complete cessation of the professional practice for the rest of man's life. For instance, an advocate would be said to have discontinued his professional practice when he takes up a full-time assignment as a judge or a legal adviser; but after retirement or resignation from the service he is entitled to return to his professional practice again.

The total income of each completed previous year or part thereof included in the period for which assessment is to be made shall be computed separately and shall be chargeable to tax at the rate or rates in force in respect of each of the relevant assessment years. Any person discontinuing his business or profession must necessarily give notice to the Assessing Officer of the fact of discontinuance within fifteen days from the date thereof. Failure to give this notice would entail the levy of penalty under section 272. Discontinuance and dissolution of business or profession by an association or a firm do not fall within the provisions of section 176 as they are dealt with under sections 177 and 189 respectively.

In the case of profession which has been discontinued, any sum received in any year on account of the cessation of the profession by, or on the retirement or death of the person carrying on profession, after the date of discontinuance is deemed to be the income of the recipient and charged to tax accordingly in his hands as if the amount would have been included in his total income if it had been received before the discontinuance. This specific provision for taxing the receipts after discontinuance of the profession thus constitutes an exception to the general rule that professional receipts would be taxable only if the profession is carried on in the year of account: section 176(4) applies only to a profession and not to a business discontinued.

According to sub-section (3A) of section 176, in cases where any business is discontinued in any year, any monies received after the discontinuance of the business must be

deemed to be the income of the recipient and must be charged to tax accordingly as his income from business in the year of its receipt if such monies would have been included in the total income of the assesses who carried on the business had such monies been actually received prior to the discontinuance of the business.

The other procedural provisions in regard to service of notice, mode of assessment, collection of tax etc. are the same as those applicable to a person leaving India, as discussed earlier.

13.8.10 Liabilities arising when an association carrying on business is dissolved or business is discontinued [Section 177]: Where any business or profession carried on by an association of persons had been discontinued or where an association of persons is dissolved the assessment officer is bound to make an assessment of the total income of the association of persons as if no such discontinuance has taken place. Consequently, all the provisions of the Act, including those relating to the levy of penalty or any other sum chargeable under the Act, apply to such an assessment. If the Assessing Officer or the Commissioner (Appeals) in the course of any proceeding under the Act, in respect of any association of persons is satisfied that the association of persons is guilty of any of the acts attracting the provisions of sections 270 to 275, he may impose or direct the imposition of a penalty in accordance with those sections.

Every person who was at the time of discontinuance or dissolution a member of the association of persons, and the legal representative of any such member who is deceased, shall be jointly and severally liable for the amount of tax penalty or other sum payable and all the provisions of the Act, so far as may be, shall apply to any such assessment, imposition of penalty etc. Where the dissolution or discontinuance had taken place after the commencement of any proceeding under the Act, the proceeding may be continued against the member of the association immediately prior to the discontinuance or dissolution and the legal representative of any deceased member from the stage at which they stood at the time of discontinuance or dissolution. The liability of the legal representative of any deceased member shall, however, be limited to the extent to which the estate is capable of meeting the liability. But if the legal representative, while his tax liability remains undischarged, creates a charge on or disposes off or parts with any of the assets of the estate of the deceased which are, or may, come into his possession, this personal liability shall, however, be limited to the value of the assets so charged, disposed of or parted with.

A society registered under the Societies Registration Act, 1860 is a legal entity separate and distinct from its members. Its members are not personally liable for the tax assessed and levied on the society, which is assessable as an association of persons so long as the society is not dissolved or its business is not discontinued *[Swami Sachitan and Vs. I.T.O. (1964) 53 I.T.R. 533].*

13.90 Income Tax

13.8.11 Companies under Liquidation [Section 178 and 179]:

1. **In the case of all companies [Section 178]:** Every person (i) who is the liquidator of any company which is being wound up, whether under the orders of a Court or otherwise, or (ii) who has been appointed as the receiver of any assets of a company is bound under a statutory obligation to give notice of his appointment as liquidator or receiver, as the case may be. This notice may be given within thirty days of his appointment to the Assessing Officer having jurisdiction to assess the income of the company. The Assessing Officer, in his turn is bound after making such enquiries or calling for such information as he may deem fit, to notify to the liquidator, within three months from the date of receipt of the notice of appointment, of the amount which in his opinion would be sufficient to provide for any tax which is then or likely thereafter to become payable by the company.

   The liquidator is debarred from parting with the assets of company and its properties in his hands until he is notified by the Assessing Officer of the amount which will be sufficient to provide for any tax which is then, or is likely thereafter, to become payable by the company except with the prior approval of the Commissioner and for a specific purpose viz., payment of the tax payable by the company, payment to secured creditors whose debts are entitled under law to priority of payments over the debts due to the Government on the date of liquidation and meeting such costs and expenses of the winding up of the company as are, in the opinion of the Chief Commissioner or the Commissioner, reasonable immediately on receipt of the notice and before parting with any of the assets of the company, directly or indirectly.

   If the liquidator fails to notify the Assessing Officer of his appointment within the time specified or fails to set aside the amount intimated by the Assessing Officer as being sufficient to provide for the tax liability of the company or parts with any of the assets or property of the company in his hands in contravention of the above provisions, he shall be personally liable for payment of the tax which the company would be liable to pay or, as the case may be, the amount intimated to him by the Assessing Officer. Failure to comply with the above requirement would be an offence punishable under section 276A.

   Where there are more liquidators than one, their obligations and liabilities under this section are joint and several. The provisions of this section have the effect of over-riding any thing to the contrary contained under the Companies Act or any other law for the time being in force and apply to all companies, public or private.

   Leave of the winding up Court is not necessary for an Assessing Officer to commence or continue the assessment proceedings against the company in liquidation. An assessment cannot, however, be made on a company after it has ceased to exist and its name has been struck off the Register of Companies by the Registrar.

- 2. **In the case of private companies [Section 179]:** Where any private company is wound up and any tax assessed on the company, whether before or in the course of its liquidation in respect of any income of any previous year cannot be recovered, then, every person who was director of a private company at any time during the relevant previous year shall be jointly and severally liable for the payment of the tax unless he proves that the non - recovery cannot be attributed to any gross neglect, misfeasance or breach of duty on his part in relation to the affairs of the company. The personal liability imposed by this section on the directors of a private company shall have the effect of over- riding any provision under the Companies Act, 1956 by which the liability of the directors is reduced or curtailed. Thus, personal liability can be imposed by the Assessing Officer on a direction even without any adjudication by a Court.

  The directors of a private company would be personally liable to pay the taxes due from the company not only at the time when the company is wound up but even in cases where the company is not in liquidation. Thus, the directors of a private company are jointly and severally liable for the payment of any tax due from a private company in respect of its income liable to tax in any accounting year from any other company in respect of any income of any previous year during which time such other company was a private company. In cases where a private company is converted into a public company and the taxes assessed in respect of any income of any previous year during which such company was a private company could not be recovered from the company, then, any tax due in respect of the income of the private company could be recovered from any of the persons who were directors of the private company before a public company. A director would be free from this personal liability to pay the taxes of the company, if he could prove that the non-recovery of the taxes due from the private company is not attributed to any gross negligence, misfeasance or breach of duty on his part in relation to the affairs of the private company.

Self-examination questions

1. Discuss briefly the concept of HUF.
2. What are the schools of Hindu Law? Discuss.
3. What are the two types of partition of HUF? What is the effect of such partitions?
4. What are the circumstances under which the income of public charitable and religious trust will be subjected to income-tax at maximum marginal rate?
5. What is meant by an oral trust under the Income-tax Act? Is the income of such a trust chargeable to tax?

6. Chapter XII-G of the Income-tax Act, 1961 contains a special scheme for taxation of the income of shipping companies. With reference to this scheme, explain the meaning of the following terms -

   (a) Operating ship;

   (b) Qualifying company;

   (c) Relevant shipping income.

7. Chapter XII-G of the Income-tax Act, 1961 contains special provisions relating to taxation of the income of shipping companies. What are the provisions contained therein relating to amalgamation and demerger of shipping companies?

8. Kanpur club was a private club which provided entertainment to its members by offering accommodation, library, reading room etc. The club also earned income by letting out its marriage hall to non-members by making them as temporary members. It contended that the "doctrine of mutuality" would apply in such a case and hence, its income would not be taxable. Discuss the correctness or otherwise of the contention of the assessee-club.

Answers

8. The concept of mutuality means that the contributors and the beneficiaries are identical. Since one cannot make a profit by dealing with oneself, there is no taxable profit involved wherever such concept applies. In this case, however, the principle of mutuality does not apply since non-members are made temporary members only for the purpose of letting out the marriage hall. This issue came up before the Kerala High Court, *in CIT v. Trivandrum Club (2006) 153 Taxman 481*. The High Court observed that the marriage hall was being rented out to non-members by making them temporary members only for the purpose of letting out the marriage hall and the amounts received from the non-members formed part of the income of the assessee-club. The principle of mutuality, therefore, would **not** apply in such a case. Thus, the contention of the assessee-club is incorrect.

14

TAX PLANNING AND ETHICS IN TAXATION

14.1 BASIC CONCEPTS

Tax planning involves an intelligent application of the various provisions of the Direct Tax Laws to practical situations in such a manner as to reduce the tax impact on the assessee to the minimum. A thorough understanding of the principles, practices and procedures of tax laws and the ability to apply such knowledge to various practical situations is expected at the final level.

14.1.1 Method of study of tax planning : A thorough up-to-date knowledge of tax laws is a pre-requisite for a successful study of tax planning techniques. Not only an up-to-date knowledge of the statute law necessary, but one must also be aware of the contents of the various circulars issued by the Central Board of Direct Taxes and also of case laws in the form of various decisions of the Courts. One of the best methods to study tax planning in action is to analyse the case laws. In view of this position, students should realise the importance and usefulness of keeping track of the judgements of Supreme Court and of various High Courts as reported in Income-tax Reports and other such journals from time to time. Students should make it a point to go through the relevant cases and understand the issues involved and the rationale of the judgements. Of course, tax planning in a particular case would depend on the facts and circumstances of that particular case.

Apart from the above, students are advised to go through the articles on tax laws published in tax journals and financial papers. They should try to refer to the various papers on topics relating to tax planning that are presented at the various seminars organised by the Institute and its Regional Councils and the Branches from time to time. These papers often contain much food for thought.

With this brief introduction, let us go into the basic concepts of tax planning.

14.1.2 Concept of tax planning : Planning is the formulation of a system which in its implementation is designed to achieve a specific result. Economic planning is the privilege of the State; tax planning is that of the subject. Men, material and money are the resources available at the disposal of a nation and to conserve the same the State resorts to economic

planning. Tax planning aims to reduce the outflow of cash resources made available to the government by way of taxes so that the same may be effectively utilised for the benefit of the individual or the business as the case may be. Just as sound economic planning is indispensable for a welfare State, a sound tax planning is equally indispensable for the welfare of the citizen.

Before entering into a transaction or before starting a business, one normally considers its profitability and other aspects. Amongst other aspects, the tax implications of the transactions of the business have to be thought out before actually embarking on the deal. Otherwise one may be caught unwittingly in huge tax liability. Planning from the point of view of taxation helps in generating greater savings of investible surplus.

Tax planning may be defined as an arrangement of one's financial affairs in such a way that, without violating in any way the legal provisions, full advantage is taken of all tax exemptions, deductions, concessions, rebates, allowances and other reliefs or benefits permitted under the Act so that the burden of taxation on the assessee is reduced to the minimum.

It involves arranging one's financial affairs by intelligently anticipating the effects which the tax laws will have on the arrangements now being adopted. As such it is a very stimulating intellectual exercise.

Any tax planning scheme should be a natural one and should not give an appearance of an artificial arrangement on the face of it. The tax planner or the tax adviser should exercise great care and caution in designing any tax planning scheme as its failure will result in great difficulties and heavy burden of tax to the assessee for whom the scheme is evolved.

14.1.3 Tax planning and tax avoidance : Reduction of taxes by legitimate means may take two forms — tax planning and tax avoidance. 'Tax planning' is wider in range. At this stage, the distinction between 'tax avoidance' and 'tax evasion' may be noted. The dividing line between tax evasion and tax avoidance is very thin. The Direct Taxes Enquiry Committee (Wanchoo Committee) has tried to draw a distinction between the two items in the following words.

"The distinction between 'evasion' and 'avoidance', therefore, is largely dependent on the difference in methods of escape resorted to. Some are instances of merely availing, strictly in accordance with law, the tax exemptions or tax privileges offered by the government. Others are maneuvers involving an element of deceit, misrepresentation of facts, falsification of accounting calculations or downright fraud. The first represents what is truly tax planning, the latter tax evasion. However, between these two extremes, there lies a vast domain for selecting a variety of methods which, though technically satisfying the requirements of law, in fact circumvent it with a view to eliminate or reduce tax burden. It is these methods which constitute "tax avoidance".

14.1.4 Judicial thinking—A brief survey : However, it is to be noted that judicial attitude towards tax avoidance schemes has distinctly hardened as is evident from the judgment of the

Supreme Court in *M/s. Mc Dowell and Co. Ltd. vs. Commercial Tax Officer 1985 Taxman 77(3)-(1985) 154 I.T.R. 148 (SC)*. Though this decision was rendered in the context of A.P. General Sales Tax Act, the principles emerging out of this decision will have relevance to direct taxes also.

Before discussing the relevant observations of the Supreme Court in relation to tax avoidance scheme it will be instructive to have an idea of the development in judicial thinking in England since our own judicial thinking on the subject has been largely derived from English thinking.

English Scene: In *Inland Revenue Commissioner vs. Duke of Westminster 1936 AC 1* it was held "Every man is entitled if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax."

After the World War II and the consequent huge profiteering and racketeering the attitude of the courts towards the avoidance of tax perceptibly changed and hardened. Commenting on a tax avoidance scheme the court observed that it scarcely lies in the mouth of the taxpayer who plays with fire to complain of burnt fingers.

It was felt that there must be some limit to the devices which courts can put up with in order to defeat the fiscal intentions of the legislature. A very significant departure from the Westminster Principle was made in *Ramsay vs. Inland Revenue Commissioners (1982) AC 300*. It was felt in that case that even though the doctrine that courts could not go behind a given genuine document or transaction to some supposed underlying substance was a cardinal principle, it must not be overstated or over-extended. While obliging the courts to accept documents or transactions, found to be genuine, as such, the doctrine did not compel the court to look at the document or transaction in blinkers isolated from any context to which it properly belonged. If it could be seen that a document or transaction was intended to have effect as a part of a nexus or series of transactions or as an ingredient of a wider transaction intended as a whole, there was nothing in the doctrine to prevent it being so regarded. To do so was not to prefer form to substance or substance to form. It was the task of the court to ascertain the legal nature of any transaction to which it was sought to attach a tax consequence and if that emerged from a series or combination of transactions, intended, apart as such, as was that series or combination which might be regarded.

Thus, two things were established. The first was a significant change in the approach adopted by the court with regard to its judicial role towards tax avoidance scheme. The second was that it was crucial when considering any such scheme to take the analysis far enough to determine where the profit, gain or loss was really to be found. It was also stated that the fact that the court accepted that each step in a transaction was a genuine step producing its intended legal results did not confine the court to consider each step in isolation for the purpose assessing the fiscal results. Thus we can say that the true principle of the decision in Ramsey was that the fiscal consequence of a preordained series of transactions intended to

operate as such, are generally to be ascertained by considering the result of the series as a whole and not by dissecting the scheme and considering each transaction separately.

In *I.R.C. vs. Burmah Shell Co. Ltd. (1982) STC 30 (Burmah)* and *Furniss (Inspector of Taxes) vs. Dawson (1984) 1 All E.R.530*, it was held that where tax avoidance was targeted through a series of transactions with no commercial or substantial value but with the only aim of avoiding tax, the Courts have to ignore the transactions and the tax liability has to be determined as if these transactions never took place.

Indian Scene: In *CIT vs. A. Raman & Co. 1 SCR 10* the Supreme Court followed the dictum of the Westminster's case. It observed that avoidance of tax liability by so arranging commercial affairs that charge of tax is distributed is not prohibited. The tax payer may resort to a device to divert the income before it accrues or arises to him. Effectiveness of the device depends not upon consideration of morality but on the operation of the Income-tax Act. Legislative injunction in taxing statutes may not, except on pain of penalty, be violated but it may lawfully be circumvented. The same view was expressed in *CIT vs. Kharwar 72 ITR 603* as follows:

"The taxing authority is entitled and is indeed bound to determine the true legal relation resulting from a transaction, if the parties have chosen to conceal by a device the legal relation, it is open to the taxing authorities to unravel the device and to determine the true character of relationship. But the legal effect of a transaction cannot be displaced by probing into the substance of the transaction."

However, the Supreme Court in Mc Dowell's case clearly departed from the above views and expressly disassociated itself with the earlier observations of the Supreme Court echoing the sentiments of Westminster principle. The court enumerated the evil consequences of tax avoidance as follows:

1. Substantial loss of much needed public revenue.
2. Serious disturbance caused to the economy of the country by the piling up of mountains of blackmoney, directly causing inflation.
3. Large hidden loss to the community by some of the best brains of the country involved in perpetual litigation.
4. Sense of injustice and inequality which tax avoidance arouses in the minds of those who are unwilling or unable to profit by it.
5. The unethical practice of transferring the burden of tax liability to the shoulders of the guileless, good citizens from those of the 'artful dodgers'.

The court felt that there was as much moral sanction behind taxation laws as behind any other welfare legislation and it was a pretence to say that avoidance of taxation was not unethical and that it stood on no less a moral plane than honest payment of taxation.

In the view of the court the proper way to construe a taxing statute while considering a device to avoid tax was not to ask whether the provisions should be construed literally or liberally, nor

whether the transaction was not unreal and not prohibited by the statute, but whether the transaction was as device to avoid tax and whether the transaction was such that the judicial process might record its approval to it.

The court felt that it was neither fair nor desirable to expect the legislature to intervene and take care of every device to avoid taxation. It was up to the court to take stock to determine the nature of the new and sophisticated legal devices to avoid tax and consider whether the situation created by the devices could be related to the existing legislation with the aid of emerging techniques of interpretation as was done in Ramsey's case to expose the devices for what they are really worth and to refuse to give judicial benediction.

The Supreme Court emphasised that tax planning may be legitimate provided it is within the framework of law and colourable devices cannot be part of tax planning. It is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by resorting to dubious methods. The Supreme Court also recommended that it is the obligation of every citizen to pay the taxes honestly without resorting to subterfuge.

It is significant to note that in deciding *Mc Dowell's case*, the Supreme Court was not content in merely adjudicating the dispute as to whether sales tax was leviable on the Central Excise paid by the purchaser on behalf of the seller and not exhibited in the bill. It also stated in this case that it decided to break away from the long tradition of earlier cases holding that tax avoidance is both legitimate and legal.

Another significant case decided by the Supreme Court, though involving a dispute relating to payment of bonus, is worthy of reference at this stage as it also reflects the same thinking as in *Mc Dowell's* case. In *Associated Rubber Industries case (1986) 157 ITR 77*, a new wholly owned subsidiary company was created with no asset of its own except investments transferred by the holding company with no business income, except receiving dividend from the transferred investments. The Supreme Court held that on facts the purpose of such a transfer of investments was nothing but to reduce the gross profits of the holding company and thereby to reduce the payment of bonus. There was no direct evidence that the subsidiary was formed as a device to reduce the gross profits of the principal company for whatever purpose. But Justice Chinnappa Reddy in passing his judgment was following the principles earlier laid down by him in *Mc Dowell's* case and was of the opinion that the transfer of shares was nothing but a device like tax evasion to avoid a welfare legislation like the Payment of Bonus Act. It was observed that it is the duty of the Court in every case where ingenuity is expended to avoid liability to taxation and welfare legislation, to get behind the smoke screen and discover the true state of affairs.

The above decision seems to have introduced a new doctrine that it is upto the court to take stock, weigh out sophisticated legal devices and expose the devices for what they really are. The fact that this new doctrine has started gaining ground very fast is seen from a quick succession of decisions, after *Mc Dowell* in *Kartikeya vs. Sarabhai* and in *Associated Rubber's* case. The above change in the trend of judicial thinking clearly shows that the line of demarcation between Tax Planning and Tax avoidance is getting thinner and thinner.

14.6 Income Tax

The decision in Mc Dowell's case and the subsequent developments have evoked lot of debate in all legal and tax circles.

The Gujarat High Court in *CIT vs. Smt. Minal Rameshchandra (1987) 61 CTR (Guj) 80* had occasion to consider the impact of *Mc Dowell's* case. The following propositions appear to emerge from the same.

(1) *Mc Dowell's* case and observations therein cannot be ignored and these are binding on all courts.

(2) *Mc Dowell's* case and observation therein should be understood in the context of questioning the legitimacy of use of artificial and transparent device and sham practices to circumvent the law.

(3) Where the arrangement cannot be dismissed as an artificial tax device (and not as a legitimate transaction), the subject can be taxed only having "regard to strict letter of the law and not merely to the spirit of the statute or the substance of the law" and had been consistently laid down earlier. In this sense there is no radical departure from law, prior to Mc Dowell case.

In *C.W.T. vs. Arvind Narottam 173 ITR 479 (SC)* judge Sabyasachi Mukerji made the following significant observations:

1. Where the language of the deed of settlement is plain and admits of no ambiguity there is no scope for considerations of tax avoidance.
2. One would wish as noted by Chinnappa Reddy in Mc Dowell's case that one could get the enthusiasm of Justice Holmes that taxes are the price of civilization and one would like to pay that price to buy civilization. But the question which many ordinary tax payers very often in a country of shortages (with ostentatious consumption and deprivation for the large masses) ask is does he with taxes buy civilization or does he facilitate the waste and ostentation of the few. Unless waste and ostentation in government spending are avoided or eschewed no amount of moral sermons would change people's attitude to tax avoidance.
3. Where the true effect on the construction of the deeds is clear, appeal to discourage tax avoidance is not a relevant consideration".

In the light of the above development we have to ascribe a proper meaning to the concept of tax-planning. We can take a cue from the structure of our tax laws.

Our tax laws tend to serve a dual purpose of collecting revenue and of achieving certain social objectives. There are in-built tax incentives which promote savings and investments in new enterprises and facilitate development of backward areas. A lot of exemptions and incentives are provided in all the direct taxes. If an assessee takes maximum advantage of these incentives, exemptions etc. and enlarges the scope of his disposable resources, there can be no objection because the legislature wants the optimum utilisation of these incentives to promote economic activity in the country. The complexity of our tax-laws makes it impossible

for even an intelligent assessee to comprehend them properly and avail all the reliefs which may be genuinely provided by such laws. Moreover, the interaction of other laws such as MRTP Act, FERA, Companies Act etc. make the exercise much more complicated. It requires, therefore, meticulous planning to bring down the tax commitments keeping in view not only the statutes but also the judge-made law. We may say that the above area properly belongs to tax-planning. In this sense there is nothing unethical about tax-planning.

Due to constant changes in the law and new court decisions, it is always necessary to have a continuous review in relation to all matters of tax planning so that appropriate changes are introduced without delay.

It may be noted that the scope of the three English cases of Ramsay, Burmah Oil Company and Dawson have been substantially narrowed by a more balanced view on tax planning in the case of 'Craven vs. White'

14.1.5 Basic framework of Direct Tax Laws : An inter-relation between them: We have today an integrated and more or less self-checking system of taxation in the field of direct taxes. The different direct taxes are so integrated that the same transaction may give rise to liability under the different Acts in different manners. All these Acts contain deeming provisions which envisage some sort of clubbing of income/wealth belonging to others. Under the Income-tax Act, it is the total income of the assessee which is chargeable to tax. Under certain circumstances (Section 60 to 64 of the Income-tax Act) even income of other persons is to be included in the assessee's total income. Under the Wealth-tax Act, it is the net wealth of the assessee as on the valuation date relevant to the assessment year which attracts tax. In computing the net wealth of the assessee as on the valuation date, certain assets transferred by the assessee and held by specified categories of persons are also sought to be included under section 4 of the Wealth-tax Act.

Thus, the same transaction might give rise to tax liability under different Acts under different circumstances. For instance, a transfer might be complete under the general law. Still, if the transfer without consideration is made to, say, the spouse of the transferor, the income arising from the transferred assets will continue to be taxed in the hands of the transferor for income-tax and the wealth will be taxed in the hands of the transferor for wealth-tax purposes. Thus there exists an intimate inter-relationship between the various direct taxes Acts and that under certain circumstances the assessee will not stand to gain from the tax point of view even by transferring the property to others.

In view of this position, a tax planner should always take into account the implications of the proposed transactions not only under the Income-tax Act but also under the other direct taxes Acts. The relevant Finance Acts should be taken into account. The relative implications should be studied and the impact of the relevant legal provisions should be taken into account.

14.1.6 Doctrine of form and substance: One of the reasons which prompts a tax payer to resort to tax planning is the existence of the doctrine of form and substance. The principle

involved in this doctrine is simple. How far Court may stretch the wording of a Statute to cover a particular set of facts, where those facts have clearly been created by a tax payer in order to avoid or minimise his tax and the literal interpretation of the Statute is not, at first sight apt to cover them? Is it possible to ignore the form of a transaction and determine the substance thereof?

In *Commissioner of Income tax vs. Motor and General Stores (P) Ltd. (1967) 66 ITR 692 (SC.)* the Supreme Court had observed that in the absence of any suggestion of bad faith or fraud the true principle is that the taxing statute has to be applied in accordance with the legal rights of the parties to the transaction. According to the court when the transaction is embodied in a document the liability to tax depends upon the-meaning and content of the language used in accordance with the ordinary rules of construction. The House of Lords in *Duke of Westminster vs. ICR (1936) 19 ATC 498* held that in considering the substance of the transaction, the legal form cannot be disregarded.

It was held in *CIT vs. B.M. Kharwar (1969) 72 ITR 603 (S.C.)* that the taxing authority is entitled and is indeed bound to determine the true legal relation resulting from a transaction. If the parties have chosen to conceal by device the legal relation, it is open to the taxing authority to unravel the device and to determine the true character of the relationship. But the legal effect of a transaction cannot be displaced by probing into 'the substance of the transaction'. This principle applies alike to cases in which the legal relation is recorded in a formal document and to cases where it has to be gathered from the evidence—oral and documentary—and the conduct of the parties to the transaction. However, this view of the Supreme Court has now been expressly disapproved by the Supreme Court in *Mc Dowell & Co. Ltd's case.*

Justice Shah in *Ram Laxman Sugar Mills vs. CIT (1967) 66 ITR 613, 617 (S.C.)* has stated that to ascertain the legal effect of a transaction, the court seeks, in the first instance, to determine the intention of the parties and if ambiguous expressions are used, the court may normally adopt such interpretation consistent with the parties thereto having acted on the assumption of its validity. Thus any claim made by a tax-payer will be scrutinized from the point of view of his intention and if there was any intention to defraud the revenue, the court will consider the transaction or the claim as fraud.

Thus we can say that unless there is clear evidence of *malafide* intention resulting in a form which is a "colourable device" or "mere legal facade" or "non-genuine" form the tax authorities are not justified in disregarding the legal form and probing into the substance of the transaction.

There are instances where form has prevailed over substance and vice-versa. Some examples have been given below.

- **Where form prevailed:** A firm transferred its business assets to a company formed for its purposes. The same business was carried by the company consisting of the erstwhile partners as its shareholders. The Income-tax Officer sought to withdraw the depreciation

allowed (the difference between sale price and written-down value) of machinery. Tribunal and High Court held that there was change only in the form of ownership as persons behind both firm and company were the same. Supreme Court held that legal form should prevail and restored the order of Income-tax Officer. This is a case where the form came to the assistance of revenue *CIT vs. B.M. Kharwar (1969) 72 ITR 603 (S.C.).*

- **Where substance prevailed:** (1) The assessee received compensation ostensibly paid for premature termination of managing agency and claimed that the receipt was not liable to tax as a capital receipt. The Supreme Court upheld the action of authorities in ignoring the legal facade which merely disguised the real intention between the parties to cloak payment of income nature as a capital one - *Juggilal Kamlapat vs. CIT (1969) 73 ITR 712 (S.C.).*

  (2) Certain shares were held in the name of others, but the deceased was the real owner of the shares as was found with reference to evidence. The High Court had held that the shares were not includible in the estate of the deceased as they were not in his name. The Supreme Court pointed out that, in substance, the deceased was the owner though only beneficially and upheld the inclusion for estate duty purposes - *CED vs. Aloke Mitra (1981) 126 ITR 599 to 611 (S.C.).*

- **Principles governing the form and substance :** Theory of interpretation of a taxing statute:

  (i) It is well settled that when a transaction is arranged in one form known to law, it will attract tax liability while, if it is entered into in another form which is equally lawful, it may not. In considering, therefore, whether a transaction attracts tax or not, the form of the transaction put through by the assessee is to be considered and not the substance thereof.

  (ii) The above rule cannot naturally apply where the transaction, as put through by the assessee, is not genuine but colourable or is a mere device. For here, the question is not one between 'form' and 'substance' but between appearance and truth.

  (iii) In deciding whether the transaction is a genuine or colourable one, it will be open to the authorities to pierce the corporate veil and look behind the legal facade at the reality of the transaction.

  (iv) Where the authorities are charged under the Act with the duty of determining the nature or purpose of and payment or receipt on the facts of a case, it is open to them to work at the substance of the matter and the formal aspect may be ignored.

  (v) Where the terms of a transaction are embodied in a document, it should not be construed only in its formal or technical aspect. While the words used should be

looked at, too much importance should not be attached to the name or label given by the parties and the document should be interpreted so as to accord with the real intention of the parties as appearing from the instrument.

As noted earlier, the decisions of the Supreme Court in the cases of *Mc Dowell, Karthikeya Sarabhai and Associated Rubber Industries,* clearly show a preference for the 'substance' over the 'form', if the circumstances of the case warrant such a preference. Where the transactions are genuine, perfectly authentic and not sham, the mere fact that the transaction results in less liability or no liability to tax should not put the transaction to a legal scrutiny questioning the substance of the transaction, attributing a motive behind it. It is up to the Court to take stock of the situation, weigh out sophisticated legal devices and expose the devices for what they really are.

14.1.7 Successful tax planning — tests to be satisfied : Tax planning in any case will entirely depend on the individual facts and circumstances. It is a tool in the hands of the taxpayer and tax practitioners for selective use. It is essential to comprehend (a) that the facts bearing on the issue are evidenced by proof; (b) that the associated legal consequences, both under the personal and under the tax laws, are fully borne in mind; and (c) that the situation warrants implementation of "tax planning". Successful tax planning must conform to two outstanding tests viz, (a) conformity with the current law and (b) flexibility.

In order to satisfy the first test the essential requisite is a comprehensive knowledge of the law, rules and regulations on the part of the tax planner. This knowledge of law extends not only to the provisions of the taxing statutes and the case law that has developed on those statutes, but also to other branches of law, both civil and personal, so that the tax planner's device does not get defeated by the universal principles of jurisprudence. *The second test* of flexibility seeks to ensure that the success of the tax planning device is not nullified by statutory negation. Though the tax planner may be successful in seeking out a device which in his opinion is in conformity with law, the subsequent statutory negation may nullify his success. In order to counter this exigency, his tax plan must be flexible. Flexibility essentially means that the device provides for suitable changes in accepted forms. Flexibility is a practical concept. Its introduction and utilisation depend upon the circumstances of the case. Under certain circumstances flexibility may be of no avail. As a matter of fact, flexibility may invalidate the tax plan. But when flexibility is permissible the tax planner will do well to remember to keep this test in mind to counter the measures of statutory negation. In view of this position wherever possible, tax planning schemes should be flexible, designed so as to avoid irretrievable situations. The tax planner should therefore be watchful of all significant developments related to his field.

In order to be a successful venture, efforts at tax planning should not ignore the legislative intent; they should be directed in every case to see that not only the tax benefits are obtained but also the tax obligations are discharged without fail so that the penal provisions are not attracted.

14.1.8 Retrospective Legislation: Every tax planner will inevitably have to face the question of retrospective legislation and the specific problems arising from the retrospective application of tax rates and tax amendments. Tax planning often flounders on the rock of retrospective legislation. The cardinal principle of construction is that a statute must always be interpreted prospectively unless the language of the statute makes it retrospective either expressly or by necessary implication. A retrospective operation is not to be given to a statute so as to impair vested rights or the legality of past transactions.

It is judicially settled that the law to be applied to the assessment is the law as it stands in the year of assessment and not that during the year in which the income was earned. Thus, in income-tax matters the law to be applied is the law in force in the assessment year unless otherwise stated or implied i.e., the law as it stands on 1st April, the commencement of the assessment year. Any amendment that comes into force after 1st April of the year of assessment, will not be applicable even if the assessment is actually made after the amendment comes into force.

Unless the terms of statute expressly so provide or unless there is a necessary implication, retrospective operation should not be given to the statute so as to affect, alter or destroy any right already acquired or to revive any remedy already lost by efflux of time. If the law is amended so as to make it applicable retrospectively to any assessment year, the question at issue in respect of the assessment year will have to be decided in the light of the law so amended and it shall be so even if the matter is at the appellate, revisional or reference stage.

The history of tax laws of our country is replete with instances of retrospective amendment of law. It is obviously competent for the Legislature, in its wisdom, to make the provisions of an Act of Parliament retrospective and no one denies the competency of the Legislature to pass retrospective statutes if they think fit and many time they have done so, but, before giving such a construction to an Act of Parliament one would require that it should either appear very clearly in the terms of the Act or arise by necessary and distinct interpretation. A retrospective operation is not to be given to a statute as to impair existing right or obligation otherwise than as regards matters of procedure unless that effect cannot be avoided without doing violence to the language of the enactment. If the enactment is expressed in language which is fairly capable of either interpretation, it ought to be construed as prospective only.

In our country, the Government generally follows the principle that the changes in the rates of tax, as also the other amended provisions of tax laws, should ordinarily be made operative prospectively in relation to current incomes and not in relation to incomes of the past year. However, there are cases where the Government have thought it fit to introduce retrospective amendments in tax laws. The Supreme Court has upheld the validity of such retrospective laws. Any retrospective legislation has two aspects. For pending assessments, the amended provision would be applied. The difficulty would arise in the case of completed assessments. The effect of a retrospective legislative amendment is that the provisions as amended, shall, for all legal purposes be deemed to have been included in the statute from the date on which

the amendment came into force. All orders relating to periods subsequent to the date of retrospective amendment must be in consonance with the specific and clear provisions, as amended retrospectively. Therefore, the case will be construed as if there is mistake apparent from the record which can be rectified under Section 154 *[M.K. Venkatachalam vs. Bombay Dyeing and Manufacturing Co. Ltd. (1958) 34 I.T.R. 134 (S.C.)].* Conversely, by virtue of a retrospective amendment, an order which was inconsistent with the clear terms of a provision at the time when the order was made, may become one in consonance with that provision and thereafter there remains no scope for passing a rectification order *[SAL. Narayana Rao vs. Ishwarlal Bhawan Das (1965) 57 L T.R. 149 (S.C.)].*

In case of retrospective legislation, the completed assessments may either be rectified or reopened to give effect to the amendments, provided, of course, the time limits therefor under the relevant provisions have not expired. A prudent tax planner should also take into account in appropriate cases the impact of possible retrospective amendment of law.

Relevant case law -

- **Whether Explanation to section 32 inserted by Finance Act, 2001 w.e.f. 1.4.2002 has retrospective effect?**

  CIT v. Kerala Electric Lamp Works Ltd. (2003) 129 Taxman 549 (Ker.)

  The assessee filed the return of income for A.Y. 1989-90 showing loss. It did not claim any allowance of depreciation. However, the Assessing Officer held that the depreciation was to be allowed irrespective of whether the assessee claimed it or not and, accordingly, computed the allowance and carried forward the same to be set off against its income of the subsequent years. The Assessing Officer's view was based on Explanation 5 to section 32 which clarifies that depreciation allowable under section 32(1) is mandatory and therefore shall be allowed even if the assessee has not claimed the deduction in respect of depreciation in computing his total income. The Commissioner (Appeals) confirmed the view of the Assessing Officer.

  On further appeal, the Tribunal held that when the assessee did not make a claim or a request for depreciation, there was no justification in allowing the deduction by the Assessing Officer.

  The Kerala High Court held that the Explanation 5 to section 32, inserted as per the Finance Act, 2001, was given effect to only with effect from 1.4.2002 and when the Legislature has expressly given effect to the Explanation from 1.4.2002, there was no force in the contention raised by the revenue that de hors the express provision, the section should be given retrospective effect contrary to the legislative intention.

  The section as it stood prior to the Explanation having been understood and declared by the Apex Court in *CIT v. Mahendra Mills (2000) 243 ITR 56*, there was no scope for any argument that the provision as it stood prior to the introduction of the Explanation should be understood in the same manner as though the Explanation

was there in the statute. If the Legislature actually intended to nullify the effect of the decision of the Apex Court rendered in the aforesaid decision, the Explanation added should have been given retrospective effect in express terms. On the other hand, the Legislature itself thought that the Explanation should work only prospectively. The Legislature did not intend to nullify the decision rendered prior to the amendment relating to the earlier assessment years in question. Against the express intention of the Legislature to give effect to the Explanation with effect from 1.4.02, the Court could not give any retrospective effect to the Explanation. To do otherwise would be contrary to the legislative intention.

Thus, the Explanation has no retrospective effect. The assessment year in question being related to the period prior to the insertion of the Explanation and since the question referred was covered by the decision of the Apex Court in Mahindra Mills' case, it was to be held that when the assessee did not make a claim or a request for allowance of depreciation, the Assessing Officer would not be justified in allowing the depreciation.

14.1.9 Systems and methods of tax planning: The systems and methods of tax-planning in any case will depend upon the result sought to be achieved. Broadly, the various methods of tax-planning will either be short-range tax-planning or long-range tax-planning.

The short-range tax planning has limited objective. An assessee whose income is likely to register unusual growth in a particular year as compared to the preceding year might plan to subscribe to the Public Provident Fund within the prescribed limits in order to enjoy substantial tax relief. Such a plan does not involve any permanent or long-term commitment and yet it results in substantial tax saving. This is an example of short-range tax planning.

The long-range tax planning, on the other hand, may not even confer immediate tax benefits. But it may pay-off in none too distant a future. For instance in case where an assessee transfers certain shares to his minor son, the income arising from the shares will, of course, be clubbed with the transferor's income. However, if the company subsequently issues bonus shares in respect of those shares the income arising from the bonus shares will not be clubbed with the transferor's income. Similarly the income arising out of the investment of the income from the transferred assets will not also be clubbed with the transferor's income. Long range tax planning may be resorted to even for domestic or family reasons.

In relation to income-tax the following may be noted as illustrative instances of tax-planning measures:

(a) Varying the residential status (of a limited application).

(b) Choosing the suitable form of assessable entity (individual, HUF, Firm, Co-operative society, Association of persons, Company, Trust, etc. to obtain the maximum tax concessions e.g. hotel industry in the form of a company to obtain tax holiday benefit.)

(c) Choosing suitable forms of investment (share capital, loan capital, lease, mortgages, tax exempt investments, priority sector, etc.)

(d) Programmed replacement of assets to take free advantage of the provisions governing depreciation and provisions governing investment allowance, investment deposit account scheme.

(e) Diversification of the business activities (hotel industry, agro-based industry, export-oriented industries, etc.)

(f) Division of income by over-riding title (by the creation of sub-partnership etc.)

(g) The use of the concept of commercial expediency to claim deduction in respect of expenditure, in computing business income.

14.1.10 Tax planning in the context of administrative legislation : It is a common feature of modern legislative enactment to lay down in the section of the Act, the principles and the policy of the Legislature leaving out details to be filled in or worked out by rules or regulations made either by the Government or by some other authority as may be empowered in the legislation. This kind of subordinate or administrative legislation is justified and even necessitated by the fact that the Legislature has neither the time nor the material to consider and enact rules relating to various details as they may not be acquainted fully with the facts and circumstances relating to the subject matter and may have no time to consider such details. Section 295(1) of the Income-tax Act and Section 46(1) of the Wealth-tax Act vest with the Central Board of Direct Taxes the power to make rules for carrying out the requirements of these Acts. This power also enables the Board to give retrospective effect to any of the rules in such a way as not to prejudicially affect the interests of any taxpayer.

The various matters in respect of which the rules may be framed are specified in the relevant sections. Rules are made by the appropriate authority in exercise of the powers conferred on it under the provisions of the Act. Therefore, they have statutory force and fall within the scope of the law made by the Legislature itself. Thus, they are a part of the enactment which imposes the tax. Since the rules are meant only for the purpose of carrying out the provisions of the Act, they cannot take away what is conferred by the Act nor whittle down its effect. Therefore, rules can only be made in consonance with the provisions of the Act. They must be interpreted in the light of the Section under which they are made. If there is an irreconcilable conflict between a rule and a provision in the Act, the provision in the Act is to prevail and the rule which is subordinate to the Act must give way.

Similarly, notifications are also issued in exercise of a valid authority bestowed under the statutes. Such notifications, when validly made within proper right and in exercise of the authority provided for in the law, are binding on all concerned and may be enforced. As for Press Notes, although they have no statutory force behind them, they are binding on the officers.

The following principles emerging from various rulings are relevant in this context.

1. The rule making authority cannot frame a rule which is contrary to the object and provisions of the Act from which its rule making power is derived.
2. A rule cannot over-reach the subject-matter relevant to the particular provision in the Act.
3. A rule cannot whittle down, negate or take away (directly or by implication or causation) the right, privilege, advantage or benefit granted by the section or the enactment relevant to it.
4. A rule cannot create any disability, limitation or other condition not sanctioned by the Act to which it is relevant or not consistent with the Act.
5. A subordinate authority cannot seek to sit in judgement over the rights of the subject nor decide questions of law and fact or otherwise usurp the functions of a Court.
6. No rule can be framed nor regulation promulgated contrary to the rules of natural justice.
7. A rule cannot seek to impose a tax which the Legislature has not thought it fit or expedient to impose.
8. A rule has to strictly confine itself to the subject-matter for which the rule-making authority has been empowered by the enactment.
9. In providing for a rule-making power, however wide the terms of that power be, as long as the Legislature has laid down the necessary guidelines for exercise of such rule-making power of the subordinate authority and as long as the Legislature has clearly laid down in the enactment the legislative object and policy and has retained in itself the ultimate legislative power, the enactment delegating power to a subordinate authority cannot be said to be ultra vires the Legislature or the enactment.
10. Both a rule and a provision of law are equally bound to respect the constitutional protection and fundamental right of the citizen enshrined in article 14 of the Constitution.
11. Merely because a rule is subsequently laid before the Parliament, it cannot be given the status of a law of Parliament.
12. As in the case of an enactment, if a rule classifies persons and objects into identifiable classes and such classification is relevant to the purpose of the enactment and for carrying out the provisions of the Act, it cannot be called in question.
13. A rule has no retrospective operation unless the Act to which it is relevant specifically provides for the making of rules having retrospective operation.

14. The power to notify or to exempt also carries with it necessarily the power to denotify, rescind or withdraw the notification or exemption.

The above principles may be kept in mind while deciding about embarking on tax-planning.

Section 119(1) enacts that all officers and other persons employed in the execution of that Act shall observe and follow the orders and instruction or direction of the Board, provided that no such orders, instructions or directions shall be given so as to interfere with the direction of the Deputy Commissioner 'in the exercise of his appellate functions. It is judicially settled that the Circulars issued by the Board would be binding under Section 119 on all the officers and persons employed in the execution of the Act *[Navnilal vs. Sen (1965) 56 I.T.R. (198 S.C.)]*. Consequently, if the Assessing Officer contravenes any circular issued by the Board in respect of, say, non-eligibility to tax of a certain item of receipt, he can be called upon by the appellate authority (the Deputy Commissioner or the Appellate Tribunal) to obey such a circular. The circular is not such a law that it should be taken judicial notice of; but after the circular has been brought to the notice of appellate authority, it would be competent to the appellate authority to direct the Assessing Officer to correct his mistakes in his not giving effect to the circular. However, it may be noted that opinions expressed by the Board in its individual communication to the assessee on issues affecting (for example, as to when the new industrial undertaking established by the assessee began to manufacture or produce articles within the meaning of Section 80-IA) cannot be considered as directions binding on the Income-tax authorities under Section 119. The Board is not competent to give directions regarding the exercise of any judicial power by its subordinate authorities *[J.K. Synthetics Ltd. and other vs. Central Board of Direct Taxes (1972) 83 I.T.R. 335 (S.C.)]*.

The various judicial rulings which considered the legal aspects of Circulars under the Income-tax Act point out the following.

1. The instructions of the Board are binding on the Department but not on the assessee.
2. The instructions in favour of the assessee should therefore be followed by the Department, irrespective of the question of their legality; but the instructions adverse to the assessee can be challenged by him.
3. Instructions adverse to the assessee cannot be issued with retrospective effect, while instructions favourable to the assessee can be so issued.
4. Instruction withdrawn subsequently should be given effect to by the Assessing Officer for the assessment year for which they were in force even though they are withdrawn at the a time he makes the assessment.
5. In the exercise of its power, the Board cannot impose a burden or put the assessee in a worse position but the Board can grant relief or relax the rigour of the law.

6. No instruction or circular can go against the provisions of the Act. While the Board can relax the rigours of the law or grant relief which is not to be found in the terms of the statute, no instruction which will be ultra vires of the provisions of the statute could be issued.

7. Circulars and instructions of the Board are envisaged only in regard to administrative aspects and cannot restrict the judicial power or the discretion of an officer -*ALA Firm vs. CIT 102 ITR 622 (Madras), Sirpur Paper Mills Ltd. vs. C.W.T. 77 ITR 6 (SC).*

8. No such orders, instructions or directions shall be issued — (a) so as to require any income-tax authority to make a particular assessment or to dispose of a particular case in a particular manner or (b) so as to interfere with the discretion of the Deputy Commissioner (Appeals) or the Commissioner (Appeals) in the exercise of his appellate functions.

   In making an assessment or levying a penalty, the Assessing Officer exercises a quasi-judicial power conferred on him by the Statute and has to act independently. He cannot act on advice of a stranger even though that person may be an authority superior to him in official hierarchy — *Sheo Shankar Sitaram 95 ITR 523 (All).*

9. Administrative instructions cannot also override the statutory rules.

   In view of this position, the tax planner, while planning his affairs or that of his clients must take into account not only the relevant legal provisions which affect him but also all relevant rules, notifications, circulars, etc. As for circulars, since they are in the nature of administrative or executive instructions, the possibility that they might be withdrawn by the Board at any time, should also be taken into account. They may be challenged in the Courts although, otherwise they are binding at the administrative level (i.e., below thee High Court or the Tribunal). In case where the circulars are based on erroneous and untenable footings, they are also liable to be quashed by the Court/Government.

14.1.11 System of advance rulings: A ruling is a statement in writing to a taxpayer from the prescribed tax administering authority which interprets and applies the law and regulation to a specific set of facts and states a conclusion as to the tax consequences of that particular transaction. As the rulings are given in advance of the concerned transactions they are called advance rulings. Normally the advance rulings given are binding on the tax authorities with reference to the particular cases in respect of which they are given. However, they will not bind the taxpayers. A change in the facts can affect the basis of the rulings because the law often pivots on a date, an amount, type of tax payer and so on. Likewise, a ruling issued with respect to one transaction may not be good to the same tax payer for a subsequent transaction even on what might appear to be identical facts.

Advance rulings are an excellent device for fostering and encouraging the self-assessment system and would contribute to good relations between the administration and tax paying

public. From the tax payer's point of view these rulings are most desirable because they give more assurance of certainty prior to entering into a transaction and guarantee more uniformity in the application of the tax legislation. They are desirable for the administration also as they minimise the scope for controversy and litigation, reduce the time spent in answering question from tax payers and help to achieve a fair and coordinated tax administration.

Chapter XIX-B provides for a scheme of advance rulings. For details students may refer to Chapter 23.

14.1.12 Construction and Interpretation: No tax can be imposed on the subject without words in the Act clearly showing an intention to lay a burden upon him. In other words, the subject cannot be taxed unless he comes within the letter of the law. The argument that he falls within the spirit of the law cannot avail the department. Tax and equity are strangers. In a taxing Act one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used.

(a) Natural Justice: However, this does not mean that there is no scope for natural justice. Tax laws have to be interpreted reasonably and in consonance with justice. Where a literal construction would defeat the obvious intention of the legislation and produce a wholly unseasonable result, the court must do some violence to the words and so achieve that obvious intention and produce a rational construction. If the interpretation of a fiscal enactment is open to doubts the construction most beneficial to the subject should be adopted, even if it results in his obtaining "a double advantage". A provision for exemption of relief should be construed liberally and in favour of the assessee. Likewise, a provision for appeal should be liberally construed. The law is to be ascertained by interpreting the language used in the Act in its natural meaning, uninfluenced by considerations derived from the previous state of the law. But in cases of doubt regarding the construction, assistance may be sought from previous judicial interpretation or from previous legislation or by adverting to the mischief intended to be suppressed. A subsequent enactment affords no useful guide to the interpretation of earlier law, unless it is on the same subject and the earlier law is ambiguous. An amendment may be made by the legislature only to clarify the position and not to change the law. When legislation follows a continuous practice and repeats the words on which the practice is founded, it may be inferred that the legislature in reenacting the statute intended those words to be understood in their perceived meaning.

Generally speaking, the sections in the Act do not overlap one another and each section completely covers the matter with which it deals. As far as possible the Act should be construed in such a way as to reconcile the various provisions and unravel apparent conflict into harmony bearing in mind that a general provision cannot derogate from a special provision regarding a certain class of cases. If a case

appears to be governed by either of two provisions, it is clearly the right of the assessee to claim that he should be assessed under that one which leaves him with a lighter burden.

Those sections which impose the change of levy should be strictly construed but those which deal merely with the machinery of assessment and collection should not be subjected to a rigorous construction but should be construed in a way that makes the machinery workable.

The draft of a Bill which is afterwards enacted in the form of a statute and the report of a commission or select committee appointed to deal with the subject are not admissible as aids in construing the provisions of the Act but they or the statement of objects and reasons may be referred to for the limited purpose of ascertaining the conditions prevailing at the time and the extent and urgency of the evil sought to be remedied.

(b) **Definition clause and undefined words:** A definition or interpretation clause which extends the meaning of a word should not be construed as taking away its ordinary meaning. Further, such a clause should be so interpreted as not to destroy the basic concept or essential meaning of the expression defined, unless there are competing words to the contrary. Words used in the sections of the Act are presumed to have been used correctly and exactly as defined in the Act and it is for those who assert the contrary to show that there is something repugnant in the subject or context. Words which are not specifically defined must be taken in their legal sense or their dictionary meaning or their popular or commercial sense as distinct from their scientific or technical meaning unless a contrary intention appears.

(c) **Legal fiction:** The word "deemed" may include the obvious, the uncertain and the impossible. A legal fiction has to be carried to its logical conclusion but only within the field of definite purpose for which the fiction is created. As far as possible, a legal fiction should not be so interpreted as to work injustice.

(d) **Marginal Notes:** Marginal notes to the sections cannot control the construction of the statute but they may throw light on the intention of the legislature.

(e) **Provisos:** A proviso cannot be held to control the substantial enactment or to withdraw by mere implication any part of what the main provision has given. A proviso is not applicable unless the substantive clause is applicable to the facts of the case. The proper function of a proviso is to except and deal with a case which would otherwise fall within the general language of the main enactment and its effect as confined to that case. But a proviso may be read as an independent substantive enactment where the context warrants such construction. Whether a proviso is construed as restricting the main provision or as a substantive clause it cannot be divorced from the provision to which it stands as a proviso. It must be construed harmoniously with the main enactment.

14.20 Income Tax

14.1.13 Doctrine of Precedence: Doctrine of Precedence would be applicable in case of Tax Laws. The following principles which govern the rule of precedent may be noted.

- **Supreme Court:**

1. The Supreme Court judgments are absolutely binding on all the courts, Tribunals and authorities.
2. Not only the radio decidendi, but also obiter dicta of the Supreme Court are binding on all the Courts.
3. Passing or casual observations of the Supreme Court deserve respect though they have no binding force.
4. When there are two irreconcilable decisions of the Supreme Court on some point of law, the decision of a larger Bench shall prevail.
5. When there are two irreconcilable decisions of two Benches of similar strength, the decision later in time will have to be followed by the lower courts.
6. The Supreme Court judgements cannot be ignored by the lower courts though such judgements are *per incuriam.*
7. The Supreme Court, though expected to follow its own judgements, is not bound to follow them and in appropriate cases it can review its earlier judgement

- **High Courts:**

1. A Division Bench of a High Court is generally bound by its earlier decision, but it may refuse to follow the same if the earlier judgement is per incuriam.
2. If the Division Bench of a High Court does not agree with its earlier judgement it will have either to follow the same or refer the issue to a Full Bench.
3. A Division Bench of High Court is bound to follow a decision of the Full Bench of the same High Court.
4. A single judge of a High Court is bound by a decision of a Division Bench or of the Full Bench of the same High Court.
5. A single judge of a High Court is not bound to follow the decision of another single judge, though he is expected to follow the same.
6. All the lower authorities, courts and tribunals are absolutely bound to follow the decision of a High Court within whose jurisdiction they function. Here the High Court decisions include decision of a single judge.
7. The lower authorities and courts can ignore a decision of a High Court only if it is overruled by a larger Bench of the same High Court, or by the Supreme Court or by a later enactment.

Others:

1. The Assessing Officer and the Commissioner, while acting under section 263, cannot refuse to follow the decision of High Court. They cannot pass orders which are inconsistent with the decisions of the High Court within whose jurisdiction they function, even for the purpose of keeping the issue alive.
2. In all Indian Acts like the Income-tax Act, to keep the uniformity of law, a High Court should normally follow the decision of another High Court, unless it finds an overriding reason not to follow the same.
3. The lower appellate authorities are bound to follow the decision of another High Court, though they do not function within the jurisdiction of the said High Court, if there is no contrary decision of any other High Court.
4. The Assessing Officer or the Commissioner need not follow the decision of another High Court if the department has not accepted the said decision and has taken the matter to Supreme Court.
5. The Bench of the Appellate Tribunal, should generally follow the orders of other Benches of the Tribunal, unless those orders of the Tribunal axe *per incuriam.*
6. An order of a Full Bench of a Tribunal is binding on the ordinary Bench of the Tribunal.
7. If an ordinary bench of a Tribunal does not agree with an order of another Bench of the Tribunal, and that order of the another Bench of the Tribunal is not *per - incuriam*, the Bench cannot differ from the view taken by the other Bench. It can only get the matter referred to a larger Bench. But this is subject to the general rule that as far as possible, the Bench should try to follow the orders of the Benches.
8. The Tribunal orders are binding on the Deputy Commissioner or the Commissioner (Appeals) falling within the territorial jurisdiction of the Tribunal passing the order in question.
9. The Assessing Officer and the Commissioner are bound by the order of the Tribunal (falling within the jurisdiction of the Tribunal unless the Department has not accepted the decision of the Tribunal.)
10. The Assessing Officer is not bound by the orders of the Deputy Commissioner unless the department has accepted the orders of the Deputy Commissioner.

14.1.14 Diversion of income by overriding title and application of income : The concept of 'diversion of income by overriding title' signifies diversion of income at source by an overriding title before it reaches an assessee. Such a diversion can take place either under a

legal compulsion or under a contractual obligation or otherwise. An obligation to apply the income in a particular way before it has accrued or arisen to the assessee results in the diversion of the income. On the other hand, an obligation to apply income which has accrued or arisen or has been received amounts merely to the apportionment or application of the income and not to its diversion. Sometimes the dividing line between diversion by overriding title and the application of income after it has accrued is somewhat thin.

When income or a portion of income is diverted at the source by an overriding title before it started flowing into the channel which was to reach the assessee concerned it could be excluded from his assessable income. Wherever there is such diversion of income, such diverted income, cannot be included in the total income of the assessee who claims that there has been a diversion. On the other hand, where income has accrued or arisen in the hands of the assessee, its subsequent application in any way will not affect the tax liability.

In order to decide whether a particular disbursement amounts to diversion or application of income, the true test is to probe into and decide whether the amount sought to be deducted, in truth, did not reach the assessee as his own income. It is the nature of the obligation that is the decisive fact. There is a difference between an amount which a person is obliged to apply out of his income and an amount which by the nature of the obligation cannot be said to be a part of his income. It is the nature of the obligation that is the decisive fact. There is a difference between an amount which a person is obliged to apply out of his income and an amount which by the nature of the obligation cannot be said to be a part of his income. Where, by the obligation, income is diverted before it reaches the assessee it is deductible; but where the income is required to be applied to discharge an obligation after such income reaches the assessee, the same consequence, in law, does not follow. In order that there is diversion at source of the income the obligation is to attach to the source which yields income and not to the income only. *C.I.T. vs. Sital Doss Twath 41 ITR 367 (S.C.), M.K. Brothers Pvt. Ltd. vs. CIT 86 ITR 38 (S.C.)*. In many cases it would really be a matter of proper drafting of the document creating the obligation, though, in substance, the result in both the situations may appear similar.

For the purpose of tax planning, the concept of 'diversion by overriding title' would have better scope for exploitation than the concept of 'application of income'. This is because as pointed out above where income is diverted by overriding title such diverted income is not taxed in the hands of the person who claims such diversion. On the other hand, the concept of application of income envisages first the accruing or arising of income and when once it has come within the grasp of the Income-tax Act it is liable to income-tax whatever may be its destination or whatever it may be put to. Therefore if an overriding charge is created by the assessee either voluntarily or in pursuance of an obligation, whether pre-existing or not, the assessee may be able to invoke the principle of diversion of income by overriding charge. This is, of course, subject to the provisions of Sections 60 to 64, which have the effect of getting over this principle in some situations.

Example 1 : Let us assume that an assessee owns a plot of land. As he does not have resources to develop and/or construct house property on the land, he approaches his father-in-law to make investment along with him in the construction of house property on the said plot on the basis of equal ownership in the plot and proposed building thereon. An agreement is arrived at between them providing, inter alia (i) that when the building is constructed, both the plot and the building would belong to both the parties in equal shares (ii) that each party has to contribute half share towards the cost of the land and the building and (iii) that each party would be entitled to half share each in the rental income from the said building.

Solution : Having regard to the facts and circumstance of such a case, it is obvious that this is not a case where the assessee constructs the property by merely borrowing money from his father-in-law with or without interest and with no other obligation on his part vis-a-vis the property. Nor is it a case where the assessee, having constructed the house property, agrees to part with a portion of the income in favour of someone else purely out of his volition and in the absence of any compelling circumstances obliging him to do so. On the contrary, in such cases, the payment is made in pursuance of an obligation created by a document, which is entered into before the construction is completed and on the terms and conditions of which both the parties agree to construct the property. In such a case, the payment made by the assessee of the half share of the income to his father-in-law would really be a diversion of income at source and not merely a case of application of income which accrues to him.

Example 2 : TC Ltd., a company owned a social and sports club, one of whose activities consisted of conducting horse races with amateur riders. It charged for admission into the enclosure of the club at the time of races, admission fee from the guests introduced by the members as well as from the members of the public. In accordance with the resolution passed at a General meeting, a surcharge on the entrance ticket earmarked for local charities and Indian Red Cross was levied. A separate ticket was issued for the surcharge. The receipts from the surcharge were carried separately to a separate account styled “Charity Account”. Are the receipts taxable as the income of TC Ltd.?

Solution : The question for determination is whether the amounts received on account of surcharge reached TC Ltd. as its income. The surcharge here is undoubtedly a payment which a race-goer is required to make in addition to the price of the admission ticket if he wants to witness the race from the club enclosure, but on that account it does not become part of the price for admission. The admission to the enclosure is the occasion and not the consideration for the surcharge taken from the race-goer. The surcharge is clearly a payment made for the specific purpose of being applied to local charities. Then again, it is merely a desire or intention on the part of TC Ltd. to apply the amounts received on surcharge to local charities without there being any legally enforceable obligation binding it to do so. Here a resolution

was passed at the General meeting for the levy for a particular purpose. The surcharge then paid was clearly impressed with an obligation in the nature of trust for being applied for the benefit of local charities. It thus became an allocation of a receipt for local charities before it could become income in the hands of the assessee. Such were the views expressed by the Supreme Court in *Commissioner of Income-tax vs. Tollygunge Club Ltd. (1977) 107 ITR 776 (SC)*. Similarly, it was held in *Commissioner of Income-tax vs. Bijli Cotton Mills (P) Ltd. (1979) 116 ITR 60(SC)* - dharmada realised from customers along with sale proceeds and credited to "Dharmada Account" did not constitute a part of the price and so did not form a part of the asseessee's income.

Example 3 : A legal practitioner decided to reduce his practice and to accept briefs only for paying his taxes and making charities with the fees received on such briefs. In a particular criminal case, he was at first unwilling to defend the accused, but subsequently agreed to appear on the condition that he would be provided with a sum of money for a public charitable trust that he would create. He defended the accused, was paid a sum of money by his client, and he created a trust out of that sum by executing a trust deed. Is the money received by the practitioner assessable to tax as professional income?

Solution : In this case, the client of the practitioner does not create any trust nor does he impose any obligation in the nature of a trust binding on the practitioner. Here the trust is created by the practitioner himself out of his professional income. There is no diversion of the money to the trust and it becomes professional income in the hands of the practitioner. The case is one of application of professional income as trust property and so the practitioner must pay tax on the sum of money. These were the facts and the decision in the Supreme Court case *Commissioner of Income-tax vs. Thakur Das Bhargava (1960) 40 ITR 301 (SC).*

Example 4: Certain partners of the assessee firm of Chartered Accountants retired and the firm was under legal obligation to pay outstanding fees to retiring partners in terms of the deed of the retirement.

Solution : The court held that such fee could not be treated as the assessee firm's income. In this case, as per the deed of retirement, outstanding fees falling to the share of the retiring partners until the payment was made in full to them cannot be considered to be the income of the firm. This was held to be an instance of the source being subject to an obligation. The mere collection of the income where obligation is attached to the source of such income can not be taxed as it can never be income, far less a real income. *C.I.T. vs. G. Basu & Co. 1990 (182) LT.R. 472 (Calcutta).*

Relevant cases:

1. ***CIT v. Sunil J. Kinariwala (2003) 126 Taxman 161(SC)***

`Facts of the case -

The assessee, partner of a firm, was having 10 per cent share therein. He created a trust by a deed of settlement assigning 50% out of his 10 per cent right, title and interest (excluding capital), as a partner in the firm, and a sum of Rs.5,000 out of his capital in the firm in favour of the said trust. The assessee claimed that 50% of the income attributable to his share from the firm stood transferred to the trust resulting in diversion of income at source and the same could not be included in his total income for the purpose of his assessment.

Decision -

The Supreme Court held that under the scheme of the Act, it is the total income of an assessee, computed under the provisions of the Act, that is assessable to income-tax. So much of the income which an assessee is not entitled to receive by virtue of an overriding title created in favour of a third party would get diverted at source and the same cannot be added in computing the total income of the assessee. A question arises as to what is the criterion to determine when the income attributable to an assessee gets diverted by overriding title? The determinative factor is the nature and effect of the assessee's obligation with regard to the amount in question. When a third person becomes entitled to receive the amount under an obligation of an assessee even before he could lay a claim to receive it as his income, there would be diversion of income by overriding title, but when after receipt of the income by the assessee, the same is passed on to a third person in discharge of the obligation of the assessee, it will be a case of application of income and not of diversion of income by overriding title.

There is a clear distinction between a case where a partner of a firm assigns his share in favour of a third person and a case where a partner constitutes a sub-partnership with his share in the main partnership. In the former case, in view of section 29(1) of the Indian Partnership Act, the assignee gets no right or interest in the main partnership, except, of course, to receive that part of the profits of the firm referable to the assignment and to the assets in the event of dissolution of the firm. In the latter case, the sub-partnership acquires a special interest in the main partnership. The case on hand cannot be treated as one of sub-partnership, though, the trust as an assignee, becomes entitled to receive the assigned share in the profits of the firm not as a sub-partner (because no sub-partnership came into existence) but as an assignee of the share of income of the assignor-partner. The Supreme Court therefore, held that the share of income of the assessee assigned in favour of the trust had to be included in the total income of the assessee.

2. CIT v. Madras Race Club (2003) 126 Taxman 6 (Mad.)

Facts of the case -

The assessee-race club conducted horse races. License was granted to jockeys on payment of license fee. For any violation of rules, penalties and fines were imposed. All amounts so collected were deposited in a benevolent fund created as per rule of the assessee-club. Subsequently, a trust was created for benefit of jockeys, apprentices, stable boys, etc., and the relevant rule of the benevolent fund was recasted enabling deposit of benevolent fund to the account of this trust. The assessee claimed that amounts of license fee, penalties and fines realised got diverted by reason of overriding title and became part of the benevolent fund. The assessee claimed that this sum did not form part of assessee's income. Both the Assessing Officer and the Commissioner (Appeals) rejected the assessee's claim. However, the Tribunal allowed the assessee's claim.

Decision -

The Madras High Court held that a rule framed by an assessee for its internal management cannot be elevated to the level of statutory rule and the decision on the part of the assessee to apply a portion of what is received for benevolent purposes cannot be regarded as an instance of diversion by overriding title when the amounts received by the club and allowed by it to be used by the fund were not amounts which had been paid voluntarily with the object of making payments for charitable purposes. Therefore, the impugned amounts were to be added to income of the assessee.

14.2 TAX PLANNING CONSIDERATIONS IN RESPECT OF SALARY INCOME

The scope for tax planning from the angle of employees is limited. The definition of salary is very wide and includes not only monetary salary but also benefits and perquisites in kind. The only deductions available in respect of salary income are the deduction for entertainment allowance and deduction for professional tax. Therefore, the scope for tax planning in respect of salary income is severely limited. However, the following are some ideas of tax planning in regard to salary income.

14.2.1 Salary Structure : The employer should not pay a consolidated amount as salary to the employee. If it is so paid, the entire amount of salary will become taxable without any exemption. Therefore, he can split the same and pay it as basic salary plus various allowances and perquisites. For example, the employer should include allowances as part of the salary structure of the employees for which exemption can be claimed under Rule 2BB (eg) education allowance, uniform allowance, flight allowance etc. Further, the employer can give such allowances like special compensatory allowance, border area allowance or remote area allowance or difficult area allowance or disturbed area allowance depending upon the posting of the employee. Some exemptions are available in respect of these allowances. In

this connection, Rule 2BB specifies the exempt allowances. The employer has to make a careful study and fix the salary structure in such a manner that it will include allowances which are exempt.

The employer will get a deduction of all the above amounts paid in his assessment.

14.2.2 Employees' welfare schemes : There are several employees' welfare schemes such as recognised provident fund, approved superannuation fund, gratuity fund. Payments received from such funds by the employees are totally exempt or exempt upto significant amounts. For example, gratuity received by the employee from private sector is exempt upto Rs.3,50,000. The entire provident fund received by the employee from recognised provident fund is exempt. The employer is well advised to institute such welfare schemes for the benefit of the employees. Such amount contributed by the employer towards the above funds are deductible. However, a note of caution is necessary here in view of the restrictive provisions of section 40A(9) which disallows any contribution made to any welfare funds except where such contributions are covered by section 36(1)(iv) and 36(1)(v). In this connection, it may be noted that section 10(23AAA) exempts any income of a staff welfare fund subject to the satisfaction of certain conditions. However, in the absence of an amendment to section 40A(9), contribution to such welfare trusts can be disallowed by the Assessing Officer. Further, the employer's contribution to provident fund account of the employee can be increased to 12 per cent of salary being the maximum non-taxable portion.

14.2.3 Insurance policies : Any payment made by an employer on behalf of an employee to maintain a life policy will be treated as perquisite in the hands of the employer. Further, payments received from the employer in respect of Keyman Insurance policies constitute income in the hands of the employees. However, the payment of premium by the employer on behalf of the employee will not be treated as a perquisite in the case of accident insurance policies. This is due to the fact that the employer has a vested interest in the safety of the life of his employee who is engaged in such dangerous occupations. Further, any sum paid by the employer in respect of any mediclaim premium paid by the employee to keep in force an insurance on his health or the health of any member of his family under any scheme approved by the Central Government for the purpose of section 80D is not a perquisite in the hands of the employee.

14.2.4 Dearness allowance, dearness pay : The employer should ensure that dearness allowance and dearness pay should form part of "salary". This is because certain items like entertainment allowance, gratuity, commuted pension and the employer's contribution to the recognised provident fund etc. are calculated on the basis of salary. Therefore, if dearness allowance, dearness pay etc. are included in salary, the above benefits will also increase leading to higher exemption in the hands of the employee.

14.2.5 Commission : The Supreme Court in *Gestetner Duplicators Pvt. Ltd. Vs. CIT 11 7ITR 1 (S.C.)* has held that if under the terms of employment commission is payable at a fixed percentage of turnover achieved by an employee such commission should be taken into account for calculating "salary" for the purpose of gratuity etc. The employer will be well advised to provide for such commission.

14.28 Income Tax

14.2.6 Leave travel facility : The employer should extend leave travel facility to the employees at all levels. Under section 10(5) of the Income-tax Act, exemption is provided in the hands of the employee in respect of leave travel concession. Such exemption is available for the employee, spouse, dependent children, parents, brothers and sisters.

14.2.7 Rent free accommodation/ House Rent Allowance (HRA) : An employee should analyse the tax incidence of a perquisite and an allowance, whenever he is given an option, in order to choose the one which is more beneficial to him. In the case of Rent Free Accommodation vs. HRA, it must be noted that the perquisite of rent free accommodation is taxed as per Rule 3(1) of the Income-tax Rules and HRA is exempt to the extent mentioned in section 10(13A) read with Rule 2A. The employee should therefore work out his tax liability under both the options and then decide on whether to receive HRA or choose a rent free accommodation.

14.2.8 Medical Allowances : The employer should avoid paying fixed medical allowance. This is taxable fully. Under the proviso (v) to section 17(2) any sum paid by the employer in respect of any expenditure actually incurred by the employee on his medical treatment or treatment of any member of his family will be exempt to the extent of Rs.15,000. The employer can reimburse the employee as above. Further, he can also provide free medical facilities as stipulated in the above proviso which are not taxable.

14.2.9 Uncommuted/Commuted pension : Uncommuted pension is fully taxable. Therefore, the employees should get their pension commuted. Commuted pension is fully exempt from tax in the case of government employees and partly exempt from tax in the case of non-government employees. In the case of the latter, the employees can take advantage of relief under section 89(1).

14.2.10 Provident Fund : Where an employee who is a member of a recognised provident fund and who resigns before completing five years of continuous service should ensure that he joins a firm which maintains a recognised provident fund. The accumulated balance of the provident fund with the previous employer will be exempt from tax provided the same is transferred to the new employer who also maintains a recognised provident fund.

14.2.11 Retirement benefits: Incidence of tax on retirement benefits like gratuity, commuted pension, accumulated balance of unrecognized provident fund is lower if they are paid in the beginning of the financial year.

The employer and the employees should mutually plan their affairs in such a way that retirement, termination or resignation as the case may be takes place in the beginning of a financial year.

14.2.12 Pension received by non-residents : Pension received in India by a non-resident assessee from abroad is taxable in India. If, however, such pension is first received by or on behalf of the employee in a foreign country and later on remitted to India, it will be exempt from tax.

14.2.13 Accident insurance : In respect of accident insurance policies, the decision of the Supreme Court in *CIT vs. L.W.Russel (1964) 53 ITR 91* points out that the term perquisite applied to only such sums in regard to which there was an obligation on the part of the employer to pay and a vested right on the part of the employee. If the employee has no vested interest in the policy, it cannot be considered as a perquisite. In view of this position, in cases where an employer takes out accident insurance policy covering all workmen and staff members and pays insurance premium and whenever any worker/staff member meets with an accident and the amount of claim is received from the insurance company and the same is paid away by the employer to the said worker or his family members, the premium paid by the employer in respect of group accident policies could not be considered as a perquisite, under section 17 to be added in the salary income of any employee *(CIT vs. Lala Shri Dhar (1972) 84 ITR 192)*. The amount received from insurance company on accident or death by employee or his dependents will not also be in the nature of income but a capital receipt and therefore the same will not be taxable.

14.2.14 Exempt perquisites

The following are the perquisites which are exempt from tax –

(i) Use of computers and laptop by employee;

(ii) Medical facility in employer's own hospital or a public hospital or Government or other approved hospital;

(iii) Educational benefit in a school run by employer provided value of benefit does not exceed Rs.1,000 per month per child.

14.2.15 Considerations for salary structuring

The perquisite valuation rules prescribe the method for valuing the various perquisites provided by the employer to his employees on the basis of the cost of such perquisites to the employee. For a detailed study students are advised to refer to the chapter dealing with 'Salaries'. Accordingly, the entire salary structuring for employees will have to be done after carefully weighing the pros and cons of paying a cash salary or allowing the benefit of perquisites in kind to the employees.

14.3 TAX PLANNING CONSIDERATIONS IN RELATION TO BUSINESS

The scope of income liable to tax under the head "profits and gains of business or profession" covered by Section 28 to 44D of the Income tax Act has been discussed earlier. The object of this part of the study material is to discuss from the angle of tax planning the various areas in which tax payer will have to take appropriate decisions to ensure that the incidence of tax in respect of his income chargeable under this head is reduced to the extent possible, by taking advantage of the various allowances, deductions and other tax concessions provided under the law.

14.30 Income Tax

For a new business, the spheres in which the question of tax planning is relevant are as follows:

(i) Form of the organisation

(ii) Nature of the business

(iii) Location

(iv) Financial Structure

(v) Acquisition of plant and machinery and other fixed assets

(vi) Setting up and commencement of business

Each of these aspects will be considered briefly in the following paragraphs. In addition, there is lot of scope for planning with reference to the method of accounting to be employed and the various deductions and special incentives provided under the Income-tax Act. Certain special tax planning considerations relevant to specific management decisions, foreign collaboration agreements and other related matters are also discussed.

14.3.1. Form of Business Organisation : The choice of the appropriate form of business organisation will have to be thought of and decided by the person who intends to carry on business or profession at the beginning itself, because a change in the form of business organisation after the commencement of the business, would attract liabilities to tax.

A new business can be organised under any of the following forms:

1. Sole proprietorship
2. Hindu undivided family
3. Association of persons
4. Partnership firm/LLP
5. Limited liability company
6. Co-operative society

The selection of a particular form of organisation would depend not only on the tax aspect but on other considerations also, e.g., financial requirements and resources, requirement of limited liability and many other practical considerations.

However, depending upon the taxable status and level of tax liability of the owners, a selection can be made from the various forms available for setting up a new unit.

- **Sole Proprietorship :** In the case of a sole proprietorship concern, one of the important tax disadvantages would be that no allowance or relief would be available to the tax payer in computing his income from business in respect of even a reasonable amount of remuneration attributable to the services rendered by him for carrying on the business. As a result, the taxable income arrived at would be a larger amount than what it would

have been if it had been the case of, say, a private company in which the individual himself is the Managing Director. In the case of a private company, the reasonable amount of remuneration to the Managing Director, is allowable as an item of business expenditure and to the extent of this allowance, the taxable income from business would get reduced and correspondingly the incidence of tax would also be reduced.

Under sole proprietorship, the entire income of a business unit gets assessed in the hands of the same person along with other income, while the entire loss and other allowances shall be available for set off in his hands against other income. This may have some advantage in the initial years, after which the possibility of converting it into partnership may be considered; on such conversion, the questions of possible capital gains tax, etc., will have to be considered.

- **Hindu Undivided Family :** The Hindu undivided family as a unit of taxation continues to exist for the purpose of carrying on business as well and there is a large number of cases where business is carried on by the members of the family on behalf on the family. The income of the Hindu undivided family is also to be computed in the same manner as is done for a company thereby allowing a reasonable amount of remuneration or other payments made in respect of expenses incurred by the family, although such payments may be made to the members of the family (including the karta) and their relatives. Since the law does not specifically provide for the disallowance of such expenses, it is advantageous to carry on a business through the HUF wherever possible. The income of the family is computed and first taxed in the hands of the family at the rates applicable to it. The income of the family may thereafter be divided among the members of the family and the members, in such cases do not attract any liability to tax in view of the specific exemption granted under section 10(2) of the Income-tax Act. Thus, if a business is carried on by a Hindu undivided family, the advantages which are available in the case of a company could be fully availed of and in addition the members of the family would not become liable to tax when they receive any portion of the family's income.

- **Partnership Firm/LLP:** All firms *and LLPs* will be taxed at a flat rate of 30%. Further, education cess@2% and secondary and higher education cess@1% would be applicable. There will be no initial exemption and the entire income will be taxed. In computing the taxable income of a firm, certain prescribed deductions in respect of interest and remuneration have to be allowed. The share income of a firm in the hands of the partners of the firm is fully exempt. For a detailed discussion students are advised to refer to the concerned chapter on "Assessment of Various Entities".

- **Trust:** Another important form of carrying on business is through the formation of a trust. The trust may ultimately be for the benefit of the members of a particular family including the settlor. The business carried on by the trust would have the obvious advantages which are available in the case of a business carried on by a company, because, the remuneration payable to the trustees would, to the extent such remuneration is reasonable and is not excessive, be admissible as an item of business expenditure. The

members of the trust including the beneficiaries could also be employed for the purpose of carrying on the business of the trust and remuneration or other payment is not excessive or unreasonable. However, one important disadvantage that should be kept in mind is that in the case of a trust whose income includes profits and gains of business tax will be charged on the entire income at the maximum marginal rate. However, where such profits and gains are receivable under trust declared by a person by will exclusively for the benefit of any dependent relatives and such trust is the only trust so declared by him the income would be charged to tax at the appropriate rate and not maximum marginal rate. In certain cases, the clubbing provisions of Section 64 could also be applied.

- **Company:** For any large venture, requiring substantial investment and recourse to borrowed funds from banks and institutions, ordinarily the form of a limited company will have to be adopted. Within the company form of organisation, however, several alternatives exist. On the basis of the ownership and control, a company can either be organised as a widely held company, i.e. a company in which the public are substantially interested within the meaning of Section 2(18) of the Income-tax Act, 1961. Alternatively, it can be organised as a closely held company. Depending upon the choice of the form of organisation of the company, the following important tax consequences would have to be considered from the view point of tax planning:

  1. The applicability of provisions of Section 2(22)(e) regarding deemed dividend in respect of advances or loans to shareholders would also depend on the fact whether or not it is a company in which the public are substantially interested. The fact that the scope of these provision has been considerably enlarged by the amendments made in Section 2(22)(e) from time to time, should also be kept in mind. Consequently, now the provisions would apply to payments made by the company to any person who holds 10% or more beneficial interest in a closely-held company.
  2. The provisions of Section 79 regarding restrictions on carry forward of losses in the event of substantial change in the shareholding of the company also become applicable if the company is one in which the public are not substantially interested. This aspect would assume particular significance in the case of closely held companies where losses are made and shareholdings are transferred before such losses are fully absorbed.
  3. It is significant to note that domestic companies have to pay tax@15% on dividend declared, distributed or paid. For further details students may refer to the chapter dealing with “Assessment of Various Entities”.

  Thus, it can be seen that the concept of deemed dividend under section 2(22)(e) and the provisions of section 79 do not apply to a widely held company.

- **Subsidiary vs. Branch:** The Income-tax rate on foreign corporations is higher at 50% or 40%, as the case may be, (plus surcharge @2.5% if total income exceeds Rs.1 crore) as against 30% (plus surcharge of 10%, if total income exceeds Rs.1 crore) on domestic companies. This is so because distributions by the former are generally not liable to tax in India. Further, certain tax incentives available to domestic corporations are not available to foreign companies. Some instances are amortisation of preliminary expenses, expenditure on prospecting for minerals, export incentives, incentives in respect of foreign projects profits, earnings in convertible foreign exchange, export of software, tax holiday profits of ships, hotels, etc.. It is advantageous, from tax angle, for foreign corporations intending to do business in India to do so through a subsidiary instead of directly through a branch.

- **Co-operatives:** The co-operative form of business organisation, i.e., a co-operative society would also be advantageous from the tax angle and, in addition to the general benefits flowing from the co-operative form the society, can claim deduction in respect of the reasonable amount of remuneration payable to the members of the society for their services rendered, including the amount of commission, if any payable to them and the interest on the deposits or loans given by them. The co-operative society is entitled to a further tax benefit arising from section 80P under which the income of a co-operative society is exempted from tax under different circumstances depending upon the nature of the income and/or the amount thereof. In addition to the various tax concessions which are available to all assesses to the co-operative society stands to gain substantially by virtue of the special benefits available to it under section 80P. A co-operative society is taxable at low rates. The profits of the society remaining after payment of tax would be distributed by it amongst its members in the form of dividends subject to the relevant legislation.

  However, it may be noted that benefit under section 80P has been withdrawn w.e.f. A.Y.2007-08 in respect of all co-operative banks, other than primary agricultural credit societies (i.e. as defined in Part V of the Banking Regulation Act, 1949) and primary co-operative agricultural and rural development banks (i.e. societies having its area of operation confined to a taluk and the principal object of which is to provide for long-term credit for agricultural and rural development activities). This is for the purpose of treating co-operative banks at par with other commercial banks, which do not enjoy similar tax benefits.

  From the above analysis of various forms of the organisation and their treatment for income-tax purposes, it may be appreciated that the provisions of the taxation laws have a considerable influence on the entrepreneurs in their choice of particular form of the organisation that they should establish.

  An assessee cannot change the form of business organisation every year as and when he wants in view of the additional tax liabilities that would arise. For instance, if

a partnership firm is first formed and is subsequently to be converted into a private company because it is later on found that the tax liability would be less if the form of business organisation is that of a company, the conversion of a firm into a company would involve a total change in the ownership of the business thus resulting in liability to tax on capital gains and tax on deemed business profits, etc.

14.3.2 Nature of the business : Besides the form of organisation, the choice of the nature of the business also calls for appropriate planning with reference to the various special benefits available under the taxation laws to the particular kinds of industries which are not available to other kinds. Some of these benefits are of such a substantial nature that they constitute one of the major factors in the determination of the nature of the business.

Broadly, business for this purpose may be divided into two categories—trading and manufacturing business. There could be a third category involving combination of both. A hundred per cent export-oriented undertaking can also take advantage of the tax holiday provisions of section 10B, subject to fulfillment of certain conditions. If such an unit is located in a Free Trade Zone, similar deduction can be claimed under section 10A. Deduction is available under section 10AA to newly established units in Special Economic Zones.

A taxpayer carrying on manufacturing or industrial activities would be in a position to avail of the various concessions such as depreciation allowance, benefit of amortisation under Section 35, 35A, 35AB, 35D and 35E, tax holiday benefit under Section 80-IA/IB/IC/ID/IE. An important aspect that requires consideration in this context is the decision regarding type of product to be manufactured. The manufacture of any of the non-priority items specified in the Eleventh Schedule to the Income-tax Act, might disentitle the assessees, excepting small-scale industrial undertakings, to the tax holiday benefit under the provisions of Section 80-IB. This is a major factor to be considered while deciding the nature of the business that an assessee should engage in.

While deciding the nature of the business, the benefit of tax exemption or concessional treatment available in respect of certain types of income such as agricultural income, business income from hotel business, new industrial undertakings, ships, business of repairs to ocean going vessels, business of exploration, etc. of mineral oils, etc. should also be taken into account.

14.3.3 Location of business: Besides economic factors and statutory restrictions imposed by Government authorities, the concessions available under the tax laws also pay a prominent role in deciding the location of new industrial undertaking. The relevant provisions which require the attention of a tax planner are Section 10A and 10B.

14.3.4 Sources of Funds or Financial Structure: Broadly speaking, the choice in the matter of financing a new unit or business would be between capital and borrowings. New units being set up by existing units or companies would have the possibility of using retained profits. In the case of a company, the means of finance are as follows:

(i) Share capital.

(ii) Debentures.

(iii) Other borrowed moneys.

(iv) Generation of funds through profits.

The use of borrowings may have the following tax implications:

While the return on share capital is a charge on the profits after tax, the return on loans to the lenders is a charge on the profits before tax. Thus recourse to borrowings would offer a tax advantage which will be reflected in a higher rate of return on the owner's capital.

14.3.5 Acquisition of 'Fixed Assets' : Apart from other considerations relevant in the context the consequences may require a careful choice between buying or leasing some or more of the fixed assets. Assets can be bought or hired. If these are bought and are depreciable, e.g. building, plant and machinery and furniture, the assessee can claim depreciation on the cost and over the years the entire cost can be claimed as deduction against the profit. If hired, however, the charge for hire becomes an admissible deduction. Having regard to the fact that the acquisition of an asset requires a larger immediate outlay than what is necessary in the case of hiring, the company may opt for hiring in some cases rather than for straight acquisition. For example, taking the business premises on rent rather than purchasing the same may be a better proposition.

But in the case of plant and machinery, two additional considerations may arise. New plant and machinery in certain industries may enable a company to claim deduction on account of depreciation which may outweigh other considerations. Similarly, if there can be a new industrial undertaking, substantial tax benefits may be available by way of tax holiday benefit, etc. but that would require employment of new plant and machinery to a large extent. These considerations are out and out tax considerations which may prompt an assessee to make two choices—(i) not to hire plant and machinery but to purchase them and (ii) not to purchase second hand plant and machinery but to purchase them new.

In appropriate cases, the assessee may go in for second hand imported plant and machinery, satisfying the conditions laid down. In cases where an assessee opts to go for old plant and machinery, the limit regarding the use of old plant and machinery, as laid down in Section 80-IA/80IAB/IB/IC/ID/IE should be taken into consideration. Difficulties may arise in applying the 20% limit for the value of old plant or machinery for the purpose of section 80IA etc. since the concept of value to be adopted for this purpose has not been spelt out in the law and it is not clear whether such value should refer to the cost or market value or the written down value as per books or as per income-tax records. Particular care will have to be taken while planning for such a situation.

14.3.6 Setting up and commencement of production : Setting up of business in the context of the Income-tax Act, 1961 is a concept entirely confined to that Act. It is not the same as the

commencement of the business and these two concepts have been clearly distinguished for income-tax purpose. Between the date of the setting up and date of commencement, there may be an interregnum during which the assessee may be incurring expenses of a revenue nature.

Under the taxation laws, the expenditure incurred prior to the date of setting up is not normally admissible for income-tax purposes. But if those are incurred on and from the date of setting up, but before commencement of the business, they may be allowed as deduction for tax purposes provided of course they are revenue in nature and are incurred wholly and exclusively for the purposes of business.

It is now practically well settled by various judicial rulings that a business is set up as soon as it is ready to commence production and it is not necessary that actual production should be so commenced. Thus, in the case of a company established for manufacturing cement, the business is set up as soon as acquiring of limestone is commenced even if at that time the plant and machinery may not have been installed so that actual manufacturing operations may commence.

A tax planner should accordingly fix the setting up date in such a manner that the company gets the maximum scope for allowability of expenses incurred contemporaneously to the date of setting up remembering that if those are incurred prior to the setting up date those are in-admissible as direct deductions while, if such expenses are of a revenue nature and they are wholly and exclusively incurred for business purpose, and are incurred subsequent to the date of setting up, they will be admissible as normal deductions. The following examples may be noted:

(a) Such expenditure may be allowed as a revenue expenditure. Expenditure by way of brokerage, legal charges, etc. for arranging long term loans, interest on borrowing— *India Cement Ltd. vs. C.I. T. 60 I. T.R. 52 (S.C.).*

(b) Such expenditure may form part of the cost of assets on which depreciation and investment allowance may be available — *Challapalli Sugars Ltd. vs. CIT 98 ITR 167 (S.C.).*

In this context, the provisions of Explanation 8 to Section 43(1) to the effect that any interest paid or payable in connection with the acquisition of an asset, which is relatable to any period after such asset is first put to use cannot be capitalised, are relevant.

(c) Such expenditure may constitute preliminary expenditure and may be eligible for amortisation over a ten year or five year (as the case may be) period under Section 35D.

(d) Such expenditure, if being of a capital nature and if not falling under any of the three categories noted above may be disallowable and there may not be relief either on account of depreciation or amortisation.

Interest on borrowed capital

Under clause (iii) of section 36(1), deduction of interest is allowed in respect of capital borrowed for the purposes of business or profession in the computation of income under the head "Profits and gains of business or profession".

Capital may be borrowed for several purposes like for acquiring a capital asset, or to pay off a trading debt or loss etc. The scope of the expression 'for the purposes of business' is very wide. Capital may be borrowed in the course of the existing business as well as for acquiring assets for extension of existing business. Explanation 8 to section 43(1) clarifies that interest relatable to a period after the asset is first put to use cannot be capitalised. Interest in respect of capital borrowed for any period from the date of borrowing to the date on which the asset was first put to use should normally be capitalised. However, there was scope for the assessees to claim it as a revenue expenditure.

The proviso to section 36(1)(iii) provides that no such deduction will be allowed in respect of any amount of interest paid, in respect of capital borrowed for acquisition of new 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. It is significant to note here that even after the amendment the scope for claiming such interest as revenue expenditure in respect of existing business still exists.

The question of commencement of business would also have significance from the tax point of view. In the case of newly established industrial undertakings the benefit of tax holiday under the provisions of Section 10A, 10AA, 10B, 10BA or Section 80-IA/IB/IC/ID/IE start to be operative at the point of time when the undertaking commences production or manufacture and would continue for the period prescribed in these provisions.

Similarly, under the provisions of section 35, certain capital as well as revenue expenditure incurred on scientific research during the three years immediately preceding the year of commencement of business is allowed as deduction in the year of commencement of business. It may be noted that there may be an interval of time between the date of setting up of a business and the date of actual commencement thereof and merely because there is an interval of time of this type it cannot be said that the business has not been set up.

In the case of a business/profession newly set up or a source of income coming into existence in the financial year immediately preceding the assessment year, the previous year will begin with the date of setting up of the business/profession or the date on which the source of income newly comes into existence and end with the said financial year. There will be no question of change of previous year or different previous year for different sources of income.

14.3.7 Tax planning for business deductions — Some general considerations: There are several matters which affect the assessee's ability to deduct various expenses for income-tax purposes. Some of the principal considerations to be borne in mind planning for

business deductions, are given below:

Successful tax planning for business deductions pre-supposes a clear and thorough understanding of the various statutory provisions governing the deductions and an awareness of the statutory rights as well as various restrictions and conditions governing such rights. The general considerations applicable to tax planning in the field of business deductions, revolve round their-

(a) allowability.

(b) year of allowability.

(c) extent of allowability (disallowing provisions if any), and

(d) carry-forward to future years.

Often, the question of expenditure being capital or revenue and the consequences attaching to the likely treatment eventually may also be an important part of the tax planning exercise. This aspect has been discussed at a later stage.

One of the important aspects of tax planning would be to see that the maximum deduction or allowance is obtained in the earliest possible time for the purpose of determination of taxable income. Therefore, while deciding about incurring of capital and revenue expenditure, the assessee should consider the tax treatment of such expenditures and the period within which the benefit of deduction or amortisation would be obtained so that he can estimate and work out cash flow position over a period of time. While tax considerations play a major role in investment decisions, the general principles of financial management and their effect on investment decisions should not be ignored.

The tax planner should keep in mind the advantage arising out of minimising the expenditure, especially in the initial years of a business, so that the profits may be maximised and the assessee may be in a position to avail of the various tax incentives like depreciation as also the tax holiday provisions.

Normally, deductions of expenditure is allowable in the year in which it is incurred or paid depending on the method of accounting followed, viz, mercantile or cash. In other words, the expenditure to be claimed as deduction should be claimed in the relevant year. Where the assessee follows the cash system of accounting, the allowance in respect of expenses would be available only when the moneys in respect of them are actually paid by the assessee. Whereas in the case of mercantile system of accounting, if a business liability has definitely arisen in the accounting year, a deduction should be allowed. Where accounts are kept on a mercantile basis, if an expenditure is claimed on the ground that it is legally deductible, it can be claimed in the year in which the liability for the expenditure is incurred even though the payment itself is made in a subsequent year. If an assessee following mercantile system fails to claim an expense in the year in which it accrues he loses the right to claim it as a deduction altogether. He cannot claim or make any attempt to reopen the accounts of the earlier year to

which the expense relates.

The Supreme Court's decision in *C.I.T. vs. Gemini Cashew Sales Corporation (1967), 651. T.R. 642* emphasises the principle that if the liability to make the payment has arisen during the previous year, it must be appropriately regarded as the expenditure of that year and merely because the payment in respect of the expenditure is made in the subsequent year, the assessee would not be entitled to claim deduction in respect thereof in the subsequent year. As pointed out earlier, this is subject to the provisions of section 43B.

Normally, deduction can be claimed by the assessee only in respect of those expenses and losses which have been actually incurred by the assessee during the previous year, i.e. after the business is set up. But, there are some exceptions to this rule and a tax planner should be aware of the exceptions and make use of them in appropriate cases. For example, expenditure incurred on scientific research before the commencement of the business — capital or revenue during the three years immediately preceding the commencement of the business and coming within the scope of the Explanation to sections 35(1)(i) and 35(1)(ii), preliminary expenses incurred before commencement of the business and coming within the scope of section 35D, expenditure on prospecting for minerals coming within the scope of section 35E, are cases where the assessee could claim deduction in respect of the expenditure even though the expenditure was not incurred during the previous year.

Similarly, the expenditure in respect of which deduction is claimed by the assessee should not be in the nature of capital expenditure. This is again subject to the statutory exceptions contained in provisions like section 35. Again subject to the statutory exceptions, the expenditure should be incurred wholly and exclusively for the purpose of the business.

Various other expenses incurred prior to the commencement of commercial operations may, in appropriate cases, be accumulated and capitalised by being spread over the cost of various assets constructed or acquired during the pre-production period. If this is done on a proper basis, the cost of the various assets including the indirect expenses capitalised can be depreciated for tax purposes to the extent that the cost relates to assets which are themselves depreciable for income-tax purposes. This is a matter which the tax planner should bear in mind in order to ensure that expenses incurred during the construction period are properly accounted and allocated.

It is significant to note that though the normal rule is that only expenditure which is related to a business being is carried on during the previous year is deductible, expenditure during the dormant period of business but before the business has been closed could be claimed as deduction.

Similarly, expenditure incurred by a running company, in connection with a new unit which it proposes to establish may be deducted as part of the normal revenue expenditure of the business even before the new unit has in fact been established and even if the proposed new unit is ultimately abandoned.

14.40 Income Tax

It is not always necessary that the expenditure for which deduction is claimed should be entered in the books of accounts, unless specifically required by the law. For instance, in the case of certain deductions, the income-tax law provides that the assessee, in order to be eligible for the deductions, should actually write off the amount in the books of account. For example, in the case of bad debts, deduction under Section 36(1)(vii) will be allowed only if the concerned deficiency amount has been written off in the accounts of the assessee for the relevant previous year. This aspect of the problem should also be kept in mind while planning for deductions.

The Income-tax Act lists several specific deductions. A deduction falling under each category is allowable subject to the conditions and limitations, if any which may be specified. At times the restrictive conditions apply to expenditure which is prima facie suspect as, for example, transactions with relatives or associates or within the same group coming within the scope of Section 40A(2). While planning for business deductions, due regard must be had to these limitations.

In addition to the specific provisions the omnibus provision in section 37 also enables an assessee to claim deduction in respect of expenditure laid out 'wholly and exclusively for the purpose of the business' the tax planner has to take into consideration the principles emerging from the innumerable relevant judicial rulings while availing of the facility of deduction under this provision. Any expenditure incidental to business, maybe deducted except those prohibited by any provision of the Act.

Ordinarily, an expenditure which is specifically provided for should be claimed under the relevant section rather under the omnibus provision. To justify the deduction under the residual clause, all that is required is that the expenditure must have been incurred wholly and exclusively and it is not necessary to prove that the expenditure was also incurred 'necessarily' or 'reasonably". The "expenditure must have been incurred 'for the purpose of business'. These words are wider than the phrase "for the purpose of earning profits". A specific quid pro quo is not essential. It is not necessary to show that the expenditure resulted in commensurate benefit or advantage either during the same year or subsequently.

An expenditure is liable to be disallowed if it is either of a personal nature or of a capital nature. The question whether a particular expenditure is of a personal nature must be judged by reference to the assessee himself and not any other person.

- **Capital or Revenue** : Generally speaking, an expenditure is regarded as being of a capital nature, if it results in the acquisition of an asset or of an advantage or benefit of an enduring nature.

  The test with regard to the nature of the expenditure-capital or revenue - is to be applied with reference to its purpose rather than its effect. The test must be applied by reference to the assessee himself and not any other person. For instance, a company must be obliged to construct pipelines for the purpose of its business but

under conditions whereby the pipelines ultimately become the property of a municipal corporation rather than the company itself. In such a case, although the pipelines undoubtedly constitute tangible assets the expenditure may not be regarded as of a capital nature, since the assets do not belong to the company but to some other person. There are many judicial rulings to support this view. A leading case that maybe referred to in this context is *Lakshmiji Sugar Mills Co. P. Ltd. vs. C.I. T. 82 I. T.R. 376.*

For a tax planner, often selecting appropriate form of expenditure becomes important. Often capital expenditure incurred through third parties could be claimed as a revenue expenditure. For instances, expenditure incurred on purchase of land under subsidised housing scheme where land is owned by Government *[C.I.T. vs. Rupa Rice Mills 104 ITR 248 (Orissa),* contribution for construction of additions to hospital owned by another company, *[C.I.T.vs. Belapur Refratories Ltd. 109 I. T.R. 667 (Orissa)],* contribution to railways for construction of over bridge in an accident-prone site near factory *[Panyam Cements & Mineral Industries Ltd. vs. Addl. CIT 117 ITR 770 (AP)]* have been held to be deductible expenditure. Contribution of a part of cost of construction of a new road, which facilitated the operation of the assessee and enabled the management to conduct the business more efficiently without any addition or expansion of profit making apparatus of the assessee has also been held to be allowable expenditure *[L.H. Sugar Factory & Oil Mills, P.Ltd. 125 ITR 293 (SC)].*

If the purpose of the expenditure is to secure a commercial advantage, rather than acquisition of a capital asset, it is likely to be allowed as a revenue expenditure even though the advantage may endure for an indefinite period. However, this rule is by no means inflexible or capable of universal application. Conversely, if the purpose of the expenditure is the acquisition of an advantage or benefit of an enduring nature the expenditure is liable to be treated as capital expenditure even if the period or durability of the asset acquired as the result of the expenditure is very short. For example, if a company making shoes acquires knives and lasts, whose life is only three years, the expenditure may nevertheless be regarded as capital expenditure.

In applying the various case laws on the subject of distinction between capital and revenue, it should be recognised that circumstances do change and the law normally keeps pace with such changing circumstances. The expenditure that was regarded as capital expenditure resulting in long-term benefit during the relatively laissez faire days of the 19th century may not perhaps, be regarded as capital expenditure in the context of the rapid technological changes which are the feature of industrial life today. The decision of the Supreme Court in *Shahzada Nund & Sons vs. C.I. T. 108 I. T.R. 358* also supports this view. A tax planner would do well to keep track of the various cases reported from time to time so as to keep himself informed of the trend of judicial thinking in this regard.

14.42 Income Tax

- **Expenditure specifically allowed:** The Income tax Act specifically allows many types of expenditure such as depreciation, expenditure on scientific research, expenditure on know-how, preliminary expenses, bad debts etc. The Act prescribes several conditions and restrictions for the allowance of such expenditure. The tax-planner should take care to see that all the prescribed conditions are complied with so that deductions may not be denied.
- **Other business expenses** : As already explained earlier, Section 37(1) deals with the various items of expenses which are otherwise not covered by the provisions of Section 29 to 36 of the Income tax Act and specifically provides that all expenses which are incurred wholly and exclusively (though not necessarily) for the purpose of the business or profession carried on by the assessee would be deductible in computing the assessee's business income. In order to qualify for deduction under this provision, the following important conditions will have to be fulfilled:

  1. The expenditure should have been incurred by the assessee in the ordinary course of his business or profession;
  2. The expenditure should be of a revenue nature and should not be of capital nature;
  3. The expenditure should not be of a personal nature;
  4. The expenditure should not be covered by any other provisions of sections 30 to 36 for purposes of allowance and it should not also be covered by any of the provisions of disallowance contained in sections 40 to 44D; and
  5. The expenditure should not be one which is in the nature of an appropriation of income or diversion of profits by an overriding title. It should not also be one in respect of which deduction is permissible under Chapter VIA of the Income tax Act from the gross total income of the assessee.

- **Commercial expediency** : The concept of 'commercial expediency' helps a tax payer in insisting that a reasonable view is taken of his right to deduct normal expenditure. The trend in judicial thinking has also recognised this concept. This concept reflects the fact that it is virtually impossible for the legislation to list all possible deductions to which an assessee would be entitled in computing his taxable income and therefore the fact that a business has to be run by the assessee himself under normal commercial conditions must be recognised in determining the allowability of certain expenditure. The test of commercial expendiency should be applied from the point of view of a normal prudent businessman, by reference to modern concepts of social corporate/business responsibility and not by reference to the subjective standards of the revenue department.

  A claim on the ground of commercial expediency is subject to the under-noted conditions and limitations:

(a) If the expenditure is covered by one of the express provisions in the Act, it must conform to the requirements stipulated therein.

(b) An expenditure which is expressly disallowed under the Act cannot be claimed on grounds of commercial expediency.

(c) An expenditure cannot be claimed on grounds of commercial expediency if it is improper or illegal. It may be commercially expedient to pay a bribe or incur a penalty but this does not mean that the bribe or penalty would be normally deductible for tax purposes.

There is also a distinction between a payment made for a violation or breach of law and payment made for a breach of contract. In the latter case, the payment would ordinarily be deductible even though it might be described as a penalty. Courts have taken the view that where the payments are not in the nature of penalties for infraction of any law but made in pursuance of the exercise of an option given in a particular scheme and where the assessee opts for it out of commercial expediency and business consideration, it could be allowed as deduction. For instance, payments made to Export Promotion Council for shortfall in export performance and payment made to Cotton Mills Federation for non-import of allotted quota of requisite cotton, etc. were held to be allowable as payments falling in this category [vide *C.I.T. vs. Manekia Harilal Spg & Mfg. Co.Ltd. (1991) 7 Taxman 395 (Guj. C.I.T. vs. Raj Kumar Mills. Ltd. (1)1982) 135I.T.R. 812 (M.P. C.I.T. vs. Vasanth Mills Ltd. (1979) 120LT.R. 311 (Mad.)]* and other cases.

- **Tax consideration governing Management/Investment decision :** Though management/investment decisions are not based on tax factor alone, yet it has become imperative to consider tax factors before adopting any course of action because the effect of this factor is not only significant but it may also differ from one alternative to another. To illustrate this point, tax implications that are relevant while taking some specific management decisions are explained below :

- **Make or buy decision :** In making 'make or buy' decisions, the variable cost of making the product or part/component of product is compared with its purchase price in the market. The article is brought if the former is greater than the latter. Alternatively, if the decision to make involves establishment of a separate industrial unit for this purpose, a decision may be taken on the basis of total cost rather than variable cost. In such an event the assessee would also be in a position to get the tax benefits arising from allowances such as depreciation, tax holiday benefit and deduction in respect of profits from new industrial undertakings, wherever they are applicable.

  There are many other costing and non-costing considerations which are kept in mind at the time of taking the decision, like capacity utilisation, supply position of the article to be bought, terms of purchase, etc. The basis of taking make or buy decision

should be 'saving after tax'. The net saving can be ascertained after deducting from gross savings income-tax payable on the amount of saving. The long-term advantages arising out of a decision to make should also be given due weight in arriving at a decision.

At the time of ascertaining variable cost of the product (for taking make or buy decision) all taxes such as excise duty, import duty, customs duty, octroi etc., payable in the process of manufacture should be taken into account and in determining purchase price of the product all taxes to be borne by the purchaser such as sales tax, local taxes should be added for the purpose of comparison and cost of purchasing.

- **Own or lease :** Another important area of decision making is whether to own or lease (or sale and lease back). There are advantages as well as disadvantages in leasing. Leasing avoids ownership and with it the accompanying risks of obsolescence and terminal value losses. In leasing immediate payment of capital costs is avoided but fixed rental obligation arises. There are many factors which are required to be considered before making 'own or lease' decision such as cost of asset to be owned, rent of the asset to be taken on lease, source of financing the asset, risk involved in the alternatives, impact of tax concessions such as depreciation, tax holiday benefit, etc.

  Leasing can also provide important tax advantages. If the asset is taken on lease, the firm can deduct for income-tax purposes the entire rental payment. If the rate of tax is 30 per cent, then the effective rent obligation is reduced to that extent. Another tax advantage of the lease is that the life of the lease can be shortened compared to the depreciable life otherwise allowed if the assessee purchased the asset. Thus, there is a delay in paying taxes and in effect an interest free loan by the Government to the extent of the delay in taxes. There is one more tax advantage arising out of lease which arises from the opportunity to depreciate otherwise non-depreciable assets. The principal asset of this type is land. The lease rental covers the cost of the land which thus becomes deductible. This arrangement may prove particularly attractive where the land value constitutes a high percentage of the total value of the real estate or where the building is already fully depreciated. Leasing is becoming popular in India.

  Wherever possible or appropriate, the concept of sale and lease back can also be made use of as a tool for tax planning with its attendant advantages.

- **Lease rent paid:** As regards the consideration for the lease, there could be two types of receipts in the hands of the lessor-receipt on capital account termed 'premium' or 'salami' in respect of the transfer of rights and receipts on revenue account termed 'rent' for the right or liberty to use the property for a term of years.

  The lease rental paid is chargeable to revenue every year. The lease rental may be

split into three components—the recovery of principal, cost, the interest chargeable and an element of profit. It is generally believed that the interest rate in-built into the rent would be more than the going market interest rate for term loans for purchase of equipment. Since the entire lease rental is chargeable to revenue the lessee could claim tax benefits on even the principal investment in the equipment. Tax advantage in such cases is reported to be more in a leasing transaction than in a similar loaning transaction.

- **Retain or Replace Decision**: One of the important decisions which involves alternative choice is whether or not to buy new capital equipment. Both have their own merits and demerits. Generally replacement offers cost saving which results in increase in profit. But replacement requires investment of large funds resulting in extra cost. The decision is based on the relative profitability and other financial and non-financial considerations. Tax considerations should also be taken into account in this context. Some of the important considerations from the tax angle to which attention will have to be paid relate to the allowance of depreciation, as also the allowance on account of expenditure on scientific research. The applicability of the provisions for allowances should be considered and their impact ascertained before any decision is taken.

- **Tax Planning with reference to Foreign Collaborations**: Very often Indian concerns enter into foreign collaboration agreements with foreign parties. Though these agreements have various forms, the principal areas covered by them are as follows:

  1. Supply of capital goods by the foreign party.

  2. Supply of technical know-how by the foreign party to the Indian concern for (i) preparation of the lay out of the factory in India (ii) installation of plant and machinery and putting those in running order; (iii) information about working processes.

  3. Supply of raw materials.

  The tax implications of these agreements both on the foreign party and on the Indian concern are required to be known in advance. Very often the foreign collaborator wants to make sure about his tax liabilities in India and unless assured of involvement with a not too high amount of tax, the foreign party is not very eager to conclude an agreement with an Indian party. The Indian party must examine all the tax angles and devise a method which will saddle the foreign collaborator with the minimum amount of tax in India. The aim should be to arrange the affairs in such a way within the four corners of the law so as to attract the minimum amount of tax.

- **Planning:** There is much scope for planning while entering into foreign collaboration agreements. Some of the considerations relevant in this context have been briefly discussed here.

14.46 Income Tax

- **Double Taxation Avoidance Agreements**: For the determination of the taxability of foreign collaborators, the provisions of Section 90 of the Income tax Act are very relevant. This provision empowers the Central Government to enter into double taxation avoidance agreement with foreign countries. In exercise of this power, the Government has entered into such agreements with a number of foreign countries.

  Where there is an agreement between the Government of India and the Government of a foreign country, the tax liability of the foreign participant is determined in accordance with and subject to the provisions of the agreement and the Income-tax Act, to that extent, stands superseded by such agreement. In fact Circular No. 333 dated 2.4.1982, issued by the CBDT clarifies that where a double taxation avoidance agreement provides for a particular mode of computation of income the same should be followed irrespective of the provision of the Income-tax Act. Where there is no specific provision in the agreement, it is the basic law, i.e., the Income-tax Act which will govern the taxation of income.

  A non-resident desiring to enter into collaboration agreement should take care to design the same in a manner which obtains the maximum tax benefit to him whether under the normal tax laws in India or under any specific agreement between his country and India for avoidance of double taxation.

  Generally, the foreign party happens to be a non-resident for tax purposes. The status in which the chargeability to tax usually arises in the hands of the foreign party is either that of a company, or of an association of persons or of an individual. Body corporates incorporated outside India are treated as 'companies' for the purposes of Section 2(17)(ii). In the case of unincorporated foreign associations, it is advisable to obtain a declaration as a 'company' under Section 2(17)(iii) or (iv) inasmuch as tax liability otherwise would be considerable.

  From the point of view of tax planning with reference to Double Taxation Avoidance Agreements (DTAA), it is relevant to study the judgment of the Supreme Court in the case of *Union of India v. Azadi Bachao Andolan (2003) 132 Taxman 373 (SC).*

  On the facts of the case, by Circular No.682 dated 30.3.94 issued by the CBDT in exercise of its powers under section 90 of the Act, the Government of India clarified that capital gains of any resident of Mauritius by alienation of shares of an Indian company shall be taxable only in Mauritius according to Mauritius Taxation Laws and will not be liable to tax in India. Later on, because of issue of show-cause notices to some FIIs functioning in India, but incorporated in Mauritius, as to why they should not be taxed on profits and dividends in India, there was a panic and to clarify the position, CBDT issued Circular No.789, dated 13.4.2000 clarifying that FIIs, etc., which are resident in Mauritius would not be taxable in India on income from capital gains arising in India on sale of shares. The High Court quashed and set aside the Circular accepting the contention that the said circular is *ultra vires* the provisions of

section 90 and 119 and is also otherwise bad and illegal.

Section 90 – Double taxation relief - Where agreement exists

The Supreme Court held that the judicial consensus in India has been that section 90 is specifically intended to enable and empower the Central Government to issue a notification for implementation of the terms of a double taxation avoidance agreement. Therefore, the provisions of such an agreement with respect to cases to which they apply, would operate even if inconsistent with the provisions of the Income-tax Act. Circular No.789 is a circular within the meaning of section 90; therefore, it must have the legal consequences contemplated by section 90(2). In other words, the circular shall prevail even if it is inconsistent with the provisions of the Income-tax Act, 1961 insofar as assessees covered by the provisions of DTAC are concerned. Section 90 enables the Central Government to enter into a DTAC with the foreign Government. When requisite notification is issued thereunder, the provisions of section 90(2) spring into operation and an assessee who is covered by the provisions of DTAC is entitled to seek benefits thereunder, even if the provisions of the DTAC are inconsistent with the provisions of the Act.

Section 119 – Power of CBDT to issue circulars

While commenting adversely upon the validity of the impugned circular, the High Court said that "the circular itself does not show that the same has been issued under section 119; only in a case where the circular is issued under section 119, the same would be legally binding on the revenue." The Supreme Court observed that as long as the circular emanates from the CBDT and contains orders, instructions or directions pertaining to proper administration of the Act, it is relatable to the source of power under section 119 irrespective of its nomenclature. The Supreme Court held that the circular falls well within the parameters of the powers exercisable by the CBDT under section 119.

Section 4 - Charge of tax

The Supreme Court referred to the judgment of the Madras High Court in *M.V. Valliappan v. CIT (1988) 170 ITR 238* which concluded that the decision in Mc. Dowell's Co. Ltd. cannot be read as laying down that every attempt at tax planning is illegitimate and must be ignored, or that every transaction or arrangement which is perfectly permissible under law, which has the effect of reducing the tax burden of the assessee, must be looked upon with disfavour.

The views expressed in *IRC v. Duke of Westminister (1936) AC 1* reflected the prevalent attitude towards tax avoidance –

"Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of

Inland Revenue or his fellow tax gatherers may be of his ingenuity, he cannot be compelled to pay an increased tax."

The Supreme Court observed that not only is the principle in *IRC v. Duke of Westminister (1936) AC 1* alive and kicking in England, but it also seems to have acquired judicial benediction of the Constitutional Bench in India, notwithstanding the temporary turbulence created in the wake of *McDowell &Co. Ltd. v. CTO (1985) 154 ITR 148 (SC).*

The Supreme Court held that if notwithstanding a series of legal steps taken by an assessee, the intended legal result has not been achieved, the Court might be justified in overlooking the intermediate steps, but it would not be permissible for the Court to treat the intervening legal steps as non-est based upon some hypothetical assessment of the 'real motive' of the assessee.

- **Separate contracts**: The first precaution to be taken is to avoid a composite contract. Each item of work should be separately contracted for. The contracts must be separable into various parts and amount of consideration under the contract should be precisely allocated to the various segments of the contract. If possible, there should be several contracts where several services are rendered by a foreign collaborator. If this is not done there is bound to be a tussle with the Income-tax authorities. A single contract on turn key basis without specifying the various components would expose the foreign party to Indian taxation on the ground that with reference to the completed contract value income will be construed to have accrued or deemed to have accrued in India notwithstanding the fact that a substantial part of the receipt in respect of different components may have been paid abroad or a large portion of the contract may have been executed outside Indian territory.

- **Supply of capital and/or raw materials**: The goods should be purchased by the Indian party outside India. The contract for procurement and supply of plant and machinery from abroad should be on F.O.B. basis, delivery to be effected on board the ship outside India or on board the rail outside India, as the case may be. The transaction should not be done by sending R.R. or documents to banks in India with the stipulation that the Indian party should obtain the documents on payment of the price. The price should be paid by opening letters of credit and there should be no cash or constructive payment in India. If C.I.F. basis is adopted the property may be deemed to pass in the taxable territory and may attract tax on profits attributable to the procurement and supply of such plant and machinery on the ground that income accrued in India. If the foreign party agrees to supply spares for the plant during any specified period subsequent to the commissioning of the plant, the contract should be made in such a way that the obligation to supply the spare parts as per the requirements of the Indian party abroad and the payments should be stipulated to be paid and received outside India. In such a case, the supply may not attract any tax

liability in India. It would be advisable for the foreign company to purchase the items of plant and machinery from other manufacturers abroad so as to absorb the margin of profit on the purchase as a trading operation before the goods are invoiced to the Indian company on F.O.B. basis.

If the transaction can be so arranged that the ownership of the goods in question passes from the foreign seller to the Indian buyer outside the territories of India, the sale cannot be considered as having taken place in India and so the profits on such sale cannot be said to have accrued in India. Consequently, taxation in India of the foreign company on the profits on such sale on accrual basis is avoided. In practice, to avoid such liability to Indian Income-tax in the hand of the foreign company, a large number of foreign collaboration agreements or supply of goods by the foreign company to the Indian party, stipulate delivery of the goods outside India in a foreign port F.O.B., i.e. "Free on Board". The legal effect on an FOB sale at a port outside India is that as soon as the seller, i.e., the foreign company, delivers the goods to the shipper at the foreign port, the ownership in the goods is transferred by the seller to the buyer in as much as the shipper taking delivery of the goods on board the ship at the foreign port, does so as the buyer, i.e., the Indian party. The time of such transfer is the time of the delivery and the location of such transfer is the place where the delivery take place which is outside India.

Many concerns, however, are not very careful or particular about the matter of F.O.B. sales, and a considerable number of cases have been noticed where the goods are purchased on C.I.F. basis.

The expression 'C.I.F.' stands for cost, insurance and freight. In such a case, the goods continue to remain in the ownership of the seller, even after delivery to the shipper, and many instances have been found where the goods had arrived in India still continuing to remain the property of the seller. This means that when the goods are ultimately delivered to the Indian party, such delivery takes place in India and consequently, the sale itself takes place here, and so, the profits on such sale accrue in this country and become taxable in the hands of the foreign company on accrual basis. If, of course, even in a C.I.F. sale arrangements can be made for transfer of ownership while the goods are still on the high seas, the liability to Indian income-tax on accrual basis on the profits arising out of sale of goods can still be avoided. In many cases this is not done and there arises a tax liability in India to the foreign company on the sales so made, a liability which with a little foresight could easily have been avoided.

Something now requires to be said about the time of accrual. This is important for it is by the date on which an income accrues that determination is made of the assessment year in respect of which the tax liability is to be computed. The unit of period in respect of which an assessment is made is known as a 'previous year',

which is the financial year. The 'assessment year' in relation to a previous year commences on April 1.

The necessity for ascertaining the time of accrual of income is, as has been stated above, fixation of the assessment year for which the tax is to be levied. Such fixation is important, for the rules for computation of incomes and the rates for imposition of tax, are variable from assessment year to assessment year and very often these vary quite considerably.

Decided cases have established the principle that income accrues at that point of time at which the earner of the income gets the legally enforceable right for the first time to receive the income in question. Thus, when a contractor having completed his work as scheduled and also having received all the payments due on such contract, finds that there has been a loss in executing the contract and on making an application to the other party, obtains an additional sum to compensate him partially for such loss, such additional sum accrues as income not as income of the period during which the contract had been executed, but at the time when the other party agreed to pay an additional sum, i.e. when the legally enforceable right for the additional payment accrued to him.

The discussions above on accrual of income in the context of non-resident company may now be summarised with the following observations.

(1) The profits on sale of goods accrue at the place where the sale itself takes place, and, the time of such accrual is the time of such sale.

(2) If sales by the foreign party are effected F.O.B. at a place outside India, the profits on such sales accrue outside India.

(3) If services are rendered by the foreign party to an Indian party in the territories outside India, no income out of such services accrues to the foreign party in India. But there may be a 'deemed accrual' as envisaged under Section 9.

(4) If services are rendered by the foreign party in India the remuneration for such services actually accrues in India.

(5) If a foreign technician is sent to India to serve in this country for a certain period, the salaries earned for such services for the said period accrue in India. By a special provision, in Section 9 such salaries are also deemed to accrue in India

- **Receipt of Income** : It is to be noted at the outset that the Act contemplates receipt of income and not receipt out of income. Thus, if a non-resident company remits some money to India to its agent, then, such remittance being out of income or some other sum which had already been received earlier cannot constitute a case of 'receipt of income' in India; it is merely a 'receipt out of income'. This indicates that

when the Income-tax Act contemplates receipt of income, it takes account of only the first receipt. Only such first receipt may be receipt of income, any subsequent receipt or receipts can only be out of income. As had been expressed by the Supreme Court, the receipt of income for the purposes of the Income-tax Act refers to the first occasion when the recipient gets the money under his own control.

The important criterion of receipt of income is that the assessee should obtain control over the money in order that there might be a receipt of income when he gets such control for the first time. Thus a mere crediting in the payer's books, of the account of the non-resident company, without anything more, does not constitute a receipt of income all that happens by such book entries is that a relationship of debtor and creditor is established between the two parties.

But if the non-resident company issues instructions or the terms of the contract stipulate that due to prevalent difficulties like exchange control regulations, or some other matter, the Indian party is to credit the amounts due to the foreign company to the account of the latter with the former without remitting the same until definite instructions are received by the Indian party from the foreign company, the fact of such crediting pursuant to such contractual requirement, constitutes receipt of income in India on behalf of the foreign company by the Indian party. Such receipt attracts chargeability to Indian income tax.

Chargeability to Indian income-tax on receipt basis arises when income is received in India during the previous year by or on behalf of the non-resident assessee. So, if a person acting as an agent of the non-resident foreign collaborator receives any income on behalf of such collaborator in the territories of India, such income becomes chargeable to Indian income-tax in the hands of the non-resident company on the basis of the receipt thereof in India. For a long time, there existed a dispute as to whether any income could be charged to tax in India on receipt basis in the hands of a non-resident assessee selling goods to Indian parties outside India, but it has now been established firmly that when the Indian buyer remits money to the seller on account of such transactions, no income can be said to be chargeable to tax on receipt basis in this country in the hands of such non-resident person. Today the general practice is to open letters of credit with a bank outside India and to make payments to the non-resident company through such letters of credit. There are cases also where the Indian party makes the remittance of the money in question after obtaining the requisite permission from the Reserve Bank of India. In either case, there is no receipt of income in India by or on behalf of the non-resident company and so, there is no chargeability to Indian income-tax in the hands of the non-resident recipient of the money on receipt basis.

Any arrangement of payment by the buyer to the foreign seller through letters of credit opened outside India or directly after obtaining the necessary approval of

Reserve Bank of India, avoids the liability to Indian income-tax on receipt basis of the foreign collaborator in respect of income derived from sale of goods to Indian parties.

- **Shares allotted to Non-Resident**: Where shares are allotted to a non-resident participant, at the time of incorporation of an Indian company in consideration for the transfer abroad of technical know-how or services or delivery abroad of machinery and plant, the income embedded in the payments would be received in India as the shares in the Indian companies are located in India and would accordingly attract liability to income-tax as income received in India.

  As regards other payments in the nature of interest, royalty and fees for technical services, as pointed out earlier, collaboration agreements made on or after 1.4.76 (excepting those where agreement is made in accordance with the proposals approved by the Govt. before that date) are governed by the specific provisions of Section 9(1) (v), (vi) and (vii).

  The implications of the provisions of clauses (v) to (vii) of sub-section (1) to Section 9 should be carefully considered with reference to the agreement. Under these provisions, the term 'Royalty' and 'fees for technical services' are given wide meaning. However consideration which would be the income of the recipient chargeable under the head 'capital gains' would not be treated a royalty. Similarly consideration for any construction, assembly, mining or like project undertaken by the recipient chargeable under 'salaries' will not be treated as 'fees for technical services'. If the sale of the technical know-how or imparting of technical knowledge or information results in the effective transfer of title, then the receipt would be capital in nature. On the other hand, if the assets, information or knowledge is merely exploited in the course of business, receipts from such exploitation partake the character of revenue receipt liable to tax.

- **Receipt—Capital or Revenue**: One important question which is relevant in determining the foreign participant's tax liability, is whether the amount received for the supply of technical know-how is a receipt on capital account or revenue account. The answer would depend on the facts of the case. The nature of the outgoing in the hands of the Indian participant will not always be determinative of the nature of receipt in the hands of the foreign party.

  Broadly, it may be stated that a receipt from the sale of know-how would be a capital receipt only where the sale of the technical know-how or the imparting of technical knowledge and information results in the transfer or parting with of the asset or any special knowledge or property or skill which would ripen into a form of property and that, after such transfer, the transferor is deprived of using the asset. In all other cases where no capital asset or property is parted with and the transaction is merely a method of trading by which the recipient acquires the particular sum of money as profits and gains of that trade in the ordinary course of his business—the

consideration received for the sale of technical know-how will be on revenue account.

It is significant to note that under provisions as they stand today, the place of contract and/or payment is no longer material in respect of income from royalties and technical fees. In some cases liability would arise in respect of foreign collaborator's income outside India, only because the payment is made by an Indian resident, even where the income arises under the contract which is made and performed entirely outside India and neither the contract nor the receipt has any connection with India. Further the term, royalty and 'fees for technical services' have been specifically defined in a broad manner for the purposes of these provisions.

- **Foreign Personnel** : If the foreign collaboration agreement contemplates making available the services of foreign personnel to the Indian party, it would be advisable to plan in such a way as to make the foreign personnel available to the Indian concern abroad so that such personnel would be working in India as employees of the Indian concern. It is desirable to have a separate agreement in this regard. If for any reason, a single agreement becomes unavoidable, as far instance, normally in the case of agreements with Central or State Governments or Government undertakings, it would be advisable to incorporate and spell out separate, distinct and divisible services with separate consideration for each services. Such a precaution would be desirable since the problems of the foreign collaborators ultimately turn to be the problems of the Indian party as the former generally stipulates for 'tax free payments'. Even if the taxes are to be borne by the foreign party, such safeguards are equally desirable as the ultimate tax burden is bound to be reflected in the form of increased cost.

  If the foreign personnel continue to be in the employment of the foreign concerns while working in India, the services rendered by the said personnel would amount to operations carried out in India, attracting Indian tax.

  In appropriate cases, the benefits of exemption under section 10 can be claimed by the foreign technicians.

  It is significant to note that by virtue of the provisions of Section 9(I)(ii), income chargeable under the head 'salaries' payable for services rendered in India will be regarded as income earned in India and consequently will be deemed to accrue or arise in India. Therefore, even if the liability to pay such salary arises outside India, it will become taxable in India.

  Generally, it would be extremely inadvisable for any Indian party to undertake a blanket liability for all the Indian income-tax of the foreigner likely to arise out of the agreement. Insistence on the part of the foreign party to receive payments net of Indian tax in respect of the taxable items will lead to the payments to be received

being gross upon 'tax-on tax basis' at the applicable rate. Assuming that the applicable rate of tax is 20%, a net payment of Rs.80 to the foreign company will be construed as a gross payment of Rs.100 and consequently the Indian company will have to bear tax to the extent of 20% of Rs.100 and not to the extent of 20% on Rs.80.

Even in cases where the Indian party meets the tax liability of the foreign party, in his capacity as agent of the non-resident, efforts should be made to recover the tax paid from the resources of the non-residents. Failure to recover such tax would result in loss to the Indian assessee as the assessee cannot claim the same either as a bad debt or as a business expenditure or loss incidental to trade. The decisions of the Supreme Court in *CIT vs. Abdullabhai Abdul Kadar (1961) 41 ITR 545* and *Indian Aluminium Co. Ltd. vs. CIT (1971) 79 IT 514* point out this position.

- **Advance Rulings:** In appropriate cases, the facility of getting Advance Rulings, envisaged by section 245N-245V could also be availed of.
- **Double taxation relief** : Taxpayers deriving income chargeable to tax both in India and in a foreign country by virtue of their business being carried on in more countries than one or otherwise, should avail of the benefit of double taxation relief granted under Sections 90, 90A and 91 of the Income-tax Act. In order to get the benefit of relief, before starting to carry on business operations in a foreign country, the assessee should be certain whether India has entered into a double taxation relief agreement with the foreign country and, if so, the extent to which and the manner in which the relief has to be availed of. Taxpayers should prefer to derive income from those countries with which India has entered into agreement for granting relief from double taxation as compared to those countries with which no such agreement exists. Even in cases where the income is derived from a country with which India has not entered into double taxation relief agreement the assessee should claim the unilateral relief available under section 91 by proving that he has paid tax in that country on the income which accrued or arose there during the previous year. In such a case he would be entitled to a deduction from the Indian-tax-payable by him of a sum calculated on such double taxed income at the Indian rate of tax or at the rate of tax of the concerned country, whichever is the lower, or at the Indian rate of tax, if both the rates are equal. The claiming of this statutory relief would help to reduce the total incidence of tax on such doubly taxed income.

  Another aspect which will require consideration is the effect of double taxation avoidance agreements wherever they exist. To the extent specific provisions exist in such agreements, the corresponding provisions in the national law will not have application. Therefore, in understanding the tax liability in respect of technical tie-ups with foreign parties, attention will have to be paid to the relevant provisions of the double taxation avoidance agreements.

- **The provisions of section 44AB**: The provisions of section 44AB relating to compulsory tax audit should be complied with wherever applicable. As the penalty provided under section 271B for non-compliance with the above provision is very heavy, assessee should take care to ensure that they do not invite the penal provisions under which failure without reasonable cause to obtain a report of such audit might lead to payment of a penalty of sum equal to one half per cent of the total sales, turnover or gross receipts as the case may be in the business or the gross receipts in the profession in such previous year or years subject to a maximum of Rs.1 lakh.

- **Tax planning in case of losses**: The provisions of sections 70, 71 and 72 of the Income-tax Act regulate the manner in which losses incurred in the business carried on by any tax payer will have to be dealt with for tax purposes. The consideration to be given by tax payers in the matter of taking the full benefit of set-off of losses permissible under the law is as important as the considerations for tax planning which are taken into account in regard to business expenses or claiming the maximum allowances and deductions particularly in view of the fact that the provisions of set-off of losses offer valuable scope for planning.

  Under section 73 losses incurred in speculation business are to be set off only against the income from the business of speculation, if any, which the assessee may derive in the same year or in the subsequent eight years. In view of the prohibition in the matter of set-off of losses incurred in speculation business it would be in the interest of the assessee to avoid indulging in the business of speculation if it is likely to result in losses and there is no possibility of setting it off against future speculation profits within the specified period. For the purposes of set-off of losses, one of the general conditions that will have to be fulfilled is that the business or profession in the course of which the loss was incurred must continue to be carried on by the same assessee subsequently when the loss is sought to be set off against the other incomes from business. This condition does not, however, apply to speculation losses and consequently if the assessee was previously carrying on a particular type of speculation business, say, speculation in shares and stocks he may subsequently carry on speculation in commodities so that the profits from the subsequent speculation business could be utilised to set off the losses previously incurred. In other words, where the business of speculation carried on by the assessee is not profitable, he could discontinue the business of speculation in the same line so that the quantum of losses could be reduced and the assessee could resort to speculation in any other profitable field thereby taking the benefit of exception provided under the law.

14.56 Income Tax

The Supreme Court held in *CIT vs. Shantilal P. Ltd. (1983) 145 ITR 57* that a transaction cannot be described as a 'speculative transaction' within the meaning of Section 43(5), where there is a breach of a contract and on a dispute between the parties damages are awarded as compensation by an arbitration award. But where there is no dispute and damages on a pre-determined basis are payable under the contract, without actual delivery of the goods contracted for, the transaction would be a speculative one. If any loss arises out of such a speculative transaction, such speculation loss would not be available for adjustment against other business profits, if any.

The assessee should exercise his right of set off of carried forward loss at the first available opportunity. The Madras High Court held in *Tyresoles (India) vs. CIT [1963] 49 ITR 15* that where losses sustained are not set off against the profits of the immediately succeeding year or years, they cannot be set off against profits at a later date. This has been followed by the Punjab and Haryana High Court in *B.C.S. Kartar Chit Fund and Finance Co. (P.) Ltd.vs. CIT [1989] 79 CTR (P & H) 232.* Hence, as a matter of proper tax planning the assessee should exercise the right under Section 72 in the immediately succeeding year/years when the profits allow such a set off.

It is also significant to note that under section 79, a closely held company will not be entitled to claim the benefit of carry forward and set off of losses, if shares carrying at least 51% of the voting power is not held on the last day of the previous year by the same persons who held such shares on the last day of the previous year in which the loss was incurred. This benefit will not be denied if the change has occurred on account of death of a shareholder or on account of transfer by a shareholder to his relative by way of a gift. This benefit will also not be denied if the change in shareholding of an Indian company, which is a subsidiary of a foreign company, is the result of an amalgamation or demerger. However, this is subject to the condition than 51% shareholders of the amalgamating or demerged foreign company continue to be the shareholders of the amalgamated or resulting foreign company. It should be kept in mind that section 79 applies to carry forward and set off of losses and not to the benefit of deduction in respect of unabsorbed depreciation.

- **Loss Returns**: In the context of discussion on losses it would be relevant to point out that the tax planner would do well to keep in mind the implications of the provisions of section 139(3) read with section 80.

  If an assessee is to get the benefit of the determination of the loss and its carry forward under section 72(1) or 73(2) or 74(1), or 74A(3), he should file a return voluntarily within the period specified in section 139(1).

14.4 ETHICS IN TAXATION

14.4.1 Concept and significance of "Ethics" in taxation

"Ethics" in taxation relates to the extent of compliance of tax laws i.e. the ethical factor in taxation is *pari passu* to the extent of compliance of tax laws. The ethical quotient in tax management is directly proportional to tax compliance (i.e. higher the degree of compliance with tax laws, the higher is the ethical quotient and vice versa) and inversely proportional to tax avoidance (i.e. higher the degree of tax avoidance, the lower is the ethical quotient). Compliance with tax laws does not literally mean paying high taxes. Tax compliance can also be ensured by effective tax planning. Tax planning is a lawful method to keep the incidence of tax at the minimum level by making effective use of various tax exemptions, deductions, rebate, relief, beneficial circulars and judicial rulings and at the same time discharge the tax obligations properly. Tax avoidance, on the other hand, is a device which takes advantages of the loopholes in the law to reduce/avoid or transfer one's tax burden. Tax evasion is, on the extreme end, avoiding tax liability by dishonest means like concealment of income, falsification of accounts etc. Tax evasion devices are unethical and evasion, once proved, attracts heavy penalties and also prosecution.

Justice O. Chinnappa Reddy of Supreme Court has, while briefing the evil consequences of tax avoidance in *Mc.Dowell & Co. Ltd. v. CTO (1985) 154 ITR 148 (SC)*, observed that one such evil consequence is the ethics (or the lack of it) of transferring the burden of tax liability to the shoulders of the guideless, good citizens from those of artful dodgers. As regards the ethics of taxation, he observed "We now live in a welfare State whose financial needs, if backed by law, have to be respected and met. We must recognize that there is behind taxation laws as much moral sanction as behind any other welfare legislation and it is a pretence to say that avoidance of taxation is not unethical and that it stands on no less moral plane than honest payment of taxation".

A similar observation was made by Lord Chancellor *in Latilla vs. Inland Revenue Commissioner (1943) 011 ITR (E.C) 0078* -

"There is, of course no doubt that they are within their legal rights but that is no reason why their efforts, or those of the professional gentlemen who assist them in the matter, should be regarded as a commendable exercise of ingenuity or as a discharge of the duties of the good citizenship. On the contrary, one result of such methods, if they succeed, is of course to increase *pro tanto* the load of tax on the shoulder of the body of good citizens who do not desire or do not know how to adopt these manoeuvres."

14.4.2 Fundamental ethical principles to be complied with by the members of the profession

Certain fundamental ethical principles have to be adhered to by the practicing members of the CA profession to ensure compliance with tax laws and effective tax management. The

fundamental principles to be observed when developing ethical requirements relating to tax practice include all the fundamental principles by which a member is governed in the conduct of his professional relations with others. These fundamental principles are -

Integrity: A professional accountant should be straightforward and honest in performing professional services.

Objectivity: A professional accountant should be fair and should not allow prejudice or bias, conflict of interest or influence of others to override objectivity.

Professional Competence and Due Care: A professional accountant should perform professional services with due care, competence and diligence and has a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives the advantage of competent professional service based on up-to-date developments in practice, legislation and techniques.

Confidentiality: A professional accountant should respect the confidentiality of information acquired during the course of performing professional services and should not use or disclose any such information without proper and specific authority unless there is a legal or professional right or duty to disclose.

Professional Behaviour: A professional accountant should act in a manner consistent with the good reputation of the profession and refrain from any conduct which might bring discredit to the profession. The obligation to refrain from any conduct which might bring discredit to the profession requires IFAC member bodies to consider, when developing ethical requirements, the responsibilities of a professional accountant to clients, third parties, other members of the accountancy profession, staff, employers and the general public.

These fundamental principles have to be kept in mind by the tax practitioner while advising his client. Such fundamental principles when interpreted in the form of responsibilities/duties of a member as a tax practioner/tax adviser, can be translated as given below -

(i) A member rendering professional tax services is entitled to put forward the best position in favour of his client, provided he can render the service with professional competence, it does not in any way impair his standard of integrity and objectivity, and is in his opinion consistent with the law. He may resolve doubt in favour of his client, if in his judgment, there is reasonable support for his position.

(ii) A member should not hold out to clients the assurance that the tax return he prepares and the tax advice he offers are beyond challenge. Instead, he should ensure that his clients are aware of the limitations attached to his tax advice and services so that they do not misinterpret an expression of opinion as an assertion of fact.

(iii) A member who undertakes or assists in the preparation of a tax return should advise his client that the responsibility for the content of the return rests primarily with the client. The member should take the necessary steps to ensure that the tax return is properly prepared based on the information received from the client.

(iv) Tax advice or opinions of material consequence given to a client should be recorded either in the form of a letter to the client or in a memorandum for the files.

(v) A member must not associate himself with any return or communication which he has reason to believe:

(a) contains a false or misleading statement;

(b) contains statements or information furnished by the client hastily or without any real knowledge of whether they are true or false; or

(c) omits or obscures information required to be submitted and such omission or obscurity would mislead the tax department.

If any of the above situations prevails, the member's responsibility is to resign from acting as the client's tax representative.

(vi) A member may prepare tax returns involving the use of estimates only if such use is expressly authorized by the tax laws. For example, under the Income-tax Act, presumptive tax provisions can be applied to assessees carrying on retail business, civil construction and business of plying, hiring or leasing goods carriages by applying the presumptive rates specified in the Act. The limitation regarding the amount of gross receipts, number of vehicles to be owned etc. will have to be taken into account to find out whether presumptive tax provisions would apply in the assessee's case.

(vii) In preparing a tax return, a member ordinarily may rely on information furnished by his client provided that the information appears reasonable. Although the examination or review of documents or other evidence in support of the client's information is not required, the member should encourage his client to provide such supporting data, where appropriate.

In addition, the member:

(a) should make use of his client's returns for prior years whenever feasible.

(b) is required to make reasonable inquiries where the information presented appears to be incorrect or incomplete.

(viii) The member's responsibility when he learns of a material error or omission in a client's tax return of a prior year (with which he may or may not have been associated), or of the failure of a client to file a required tax return, is as follows:

14.60 Income Tax

(a) He should advise his client to file a revised return (if the time limit has not expired and assessment has not been completed) rectifying such error or omission.

(b) If the client does not correct the error:

(i) the member should inform the client that he cannot act for him in connection with that return or other related information submitted to the authorities;

(ii) the member should consider whether continued association with the client in any capacity is consistent with his professional responsibilities; and

(iii) if the member concludes that he can continue with his professional relationships with the client, he should take all reasonable steps to assure himself that the error is not repeated in subsequent tax returns.

14.4.3 Ethical considerations from the tax payer's angle and the steps taken by the Government to counteract ethical failure on the part of the tax payers

Now, let us proceed to study the ethical considerations from the tax payer's angle. The tax payer's ultimate goal is minimization of tax liability. However, ethical considerations should not be compromised for attaining this goal since an honest mistake can always be explained but the intentional error cannot. There are two roads to the taxpayer's final destination of minimizing tax liability – one is through legitimate tax planning and the other is through tax avoidance or tax evasion, which is against the law. In India, where the tax system is based largely on voluntary compliance, the taxpayer's standards of tax ethics are extremely important. The tax payer should always declare true particulars about his income, wealth, turnover or receipts and disclose correctly all material facts in the prescribed returns. He should provide correct information and furnish authentic records to the revenue, whenever statutorily required to do the same. He should not resort to concealment, misrepresentation or willful omission of any portion of his income, wealth, turnover or receipts.

There are many instances where the tax payer has compromised on compliance with these standards and this has prompted the Government to plug the loopholes which have led to erosion of tax revenue. The Government has attempted to do so by incorporation of clubbing provisions, transfer pricing provisions, introduction of new taxes, provision of mechanism for enforcing furnishing of annual information return, increasing the scope and enforcing compliance of tax deduction provisions etc. Some of the provisions which have been incorporated in the tax laws to counteract ethical failures on the part of the tax payer are discussed hereunder –

(i) Incorporation of clubbing provisions

Clubbing provisions have been enacted to counteract the tendency on the part of the tax-payers to dispose of their property or transfer their income in such a way that their tax liability can be avoided or reduced. For example, in the case of individuals, income-tax is levied on a slab system on the total income. The tax system is progressive i.e. as the income increases, the applicable rate of tax increases. Some taxpayers in the higher income bracket have a tendency to divert some portion of their income to their spouse, minor child etc. to minimize their tax burden. In order to prevent such tax avoidance, clubbing provisions have been incorporated in the Act, under which income arising to certain persons (like spouse, minor child etc.) have to be included in the income of the person who has diverted his income for the purpose of computing tax liability.

(ii) Incorporation of transfer pricing provisions

Transfer pricing provisions were brought in by the Finance Act, 2001 with a view to provide a statutory framework which can lead to computation of reasonable, fair and equitable profits and tax in India, in the case of multinational enterprises carrying on business in India, whose profits can be controlled by the multinational group, by manipulating the prices charged and paid in intra-group transactions, which may lead to erosion of tax revenue. Thus, non-compliance of ethical tax practices by multinational companies led to introduction of transfer pricing provisions.

(iii) Imposition of new/alternate taxes

(a) Minimum Alternate tax was imposed on companies consequent to the substantial increase in the number of zero-tax companies and companies paying marginal tax, inspite of having earned substantial book profits and having paid handsome dividends.

In recent years, several new taxes have been introduced with the objective of checking income-tax avoidance or establishing an audit trail.

(b) Securities Transaction Tax was introduced by the Finance (No.2) Act, 2004, on the value of taxable securities transaction i.e. purchase or sale of equity shares in a company or units of an equity oriented fund, entered into in a recognized stock exchange. This tax has to deducted at source and consequently, an assessee cannot escape paying this tax in respect of a transaction entered into in a recognized stock exchange.

(c) In the sales tax system, there was a huge revenue loss on account of a large number of instances of unaccounted transactions. State-Level Value Added Tax has been introduced with effect from 1.4.2005 to check this evasion and reduce the cascading

effects of taxes. It has increased the revenues of the State exchequer as the coverage of this tax extends to value addition at all stages of sale in the production and distribution chain. VAT is a simple and transparent tax on the final consumption of goods/services and ultimately borne by the customer, although collected at every stage of production as well as distribution and tax credit granted at each stage for tax paid earlier in the chain of transfer/sale of goods and services. Due to the inherent transparency and accountability in the system, VAT leads not only to a better tax administration but also higher levels of compliance and lesser evasion.

Tax evasion is a grave problem in a developing country like ours as it leads to a creation of a 'resource crunch' for developmental activities of the State. Reputed international institutions like the World Bank and IMF point out that the VAT regime prevents tax evasion and boosts revenues to help cash starved Governments to come out of their debt-trap. Under the VAT regime, the traders and dealers, in order to claim credit, demand invoices from the vendors thereby putting an end to the unaccounted transactions and unethical practices on account of the same.

(iv) Provision of mechanism for enforcing the furnishing of an Annual Information Return

The Finance (No.2) Act, 2004 has amended section 285BA of the Income-tax Act to provide a mechanism for enforcing the furnishing of an Annual Information Return by any assessee who enters into any prescribed financial transaction. This mechanism has been enforced for unearthing black money and counteracting unethical tax evasion by tax payers. Penalty is attracted for failure to furnish annual information return.

The excise laws also provide for furnishing of an Annual Information Statement by the assessees paying more than 100 lakhs as excise duty from account current. This Statement requires the assessee to disclose all material information regarding the value of inputs, major raw materials independently constituting for 10% or more of total value of raw materials, expenditure under specific heads, goods manufactured through job worker, sales of major finished goods which independently account for 10% or more of total value of finished goods sold, other income, job work undertaken for others etc. All such information is expected to be useful for unearthing black money.

(v) Enforcing compliance of TDS provisions

This has been enforced by denying deduction of expenditure to an assessee in case of failure to deduct tax at source or remit such tax deducted within the prescribed time. However, such expenditure would be allowed as deduction in the year in which such tax is deducted and paid. This provision is to prevent loss of tax revenue on account of failure of the assessee to deduct/remit tax. The introduction of this provision is one step to encourage ethical tax practices by assessees.

Further, TDS provisions under section 194C are attracted where the value of the contract exceeds Rs.20,000. The tax payers resorted to splitting up large contracts into contracts of smaller value to escape tax deduction. In order to prevent such unethical practice of splitting up composite contracts into contracts valued at less than Rs.20,000 to avoid tax deduction, this section was amended to require tax deduction at source where the amount credited or paid or likely to be credited or paid exceeds Rs.20,000 in a single payment or Rs.50,000 in the aggregate during the financial year.

(vi) Introduction of new valuation provisions for service tax

New section 67 providing for valuation of taxable services (w.e.f. 18.04.2006) has been introduced vide Finance Act, 2006. Further, new Service Tax Valuation Rules have also been notified w.e.f.19.04.2006. These provisions were introduced to curb the unethical practices adopted by the service tax assesses while valuing their services for the purpose of charging service tax. Service providers in order to avoid service tax liability did not show the full amount of the consideration as the value of the taxable service, instead it used to be split up in the form of reimbursements. The new provisions ensure that the gross amount charged for the services is liable to service tax including the reimbursements. Only if the expenses have been incurred by the service provider as a "pure agent" the reimbursements would be excluded from the value of the service tax.

(vii) Clubbing of clearances/taxable services in case of SSI exemption

Small scale exemption is available if aggregate value of clearances of excisable goods for home consumption by a manufacturer from one or more factories, or from a factory by one or more manufacturers does not exceed the prescribed limit of Rs.400 lakh. Sometimes to avail this benefit, manufacturers split up their clearances by opening another sham or fake unit under different partnerships or under different companies. Similar is the case with service tax. Clubbing of clearances or turnover in case of excisable goods and taxable services checks such unethical practices.

14.4.4 Role of judiciary in enforcing ethical compliance by tax payers

Tax payers also tend to distort "ethics" by resorting to unfair accounting and business practices like -

1. Claiming personal expenditure as business expenditure;
2. Claiming capital expenditure as revenue expenditure;
3. Treating revenue receipt as capital receipt;

4. Accounting for amount paid as "Salaries" as business expenditure by classifying the same under different account heads like conveyance, tour and travel, employee welfare etc.;
5. Altering the form of transaction;
6. Breaking up of large value contracts into smaller contracts to avoid attracting TDS provisions;
7. Breaking up of cash payments in respect of an expenditure to escape disallowance of such expenditure;
8. Transferring their income/property to avoid tax, etc.
9. Splitting up the turnover of excisable goods and taxable services in order to claim small scale exemption;
10. Not disclosing correct turnover figures in case of excisable goods and taxable services;
11. Resorting to unfair practices while valuing goods or services for the purpose of paying excise duty, customs duty and service tax respectively;
12. Misclassifying goods and services to avoid excise duty, customs duty and service tax.

The Courts have condemned such unethical practices by tax payers and have respected the importance of compliance with ethical standards in their judgements. Let us consider some cases in this perspective. There are several cases where companies/firms have claimed foreign travel expenses of spouses of directors/partners as a business expenditure. In some cases, the Courts have allowed such expenditure as deduction and in others, such expenditure has been disallowed. Expenditure incurred by the assessee-firm on the foreign tour of the wife of the senior partner was held non-deductible by the Madras High Court in *CIT v. T.S. Hajee Moosa & Co. (1985) 153 ITR 422*. In *CIT v. Ram Bahadur Thakur Ltd. (2003) 261 ITR 390 (Ker.)*, the High Court held that it was the assessee's obligation to prove the business expediency of overseas travel by the wives of directors. The assessee has to discharge such obligation in good faith keeping in mind the ethical standards. The introduction of Fringe Benefit Tax will to some extent discourage unethical practices in this regard.

In *CIT v. Madras Refineries Ltd. (2004) 266 ITR 0170*, social costs incurred by a company have been allowed as deduction. The High Court held that the concept of business is not static. It has evolved over a period of time to include within its fold the concrete expression of care and concern for the society at large and the people of the locality in which the business is located in particular. Further, to be known as a good corporate citizen brings goodwill of the local community, as also with the regulatory agencies and the society at large, thereby creating an atmosphere in which the business can succeed in a greater measure with the aid

of such goodwill. This decision has recognized the concept of corporate social responsibility, which also highlights compliance of ethical standards by corporates.

In *M.M.Fisheries (P) Ltd. v. CIT (2005) 277 ITR 0204*, the company claimed depreciation in respect of an asset owned by its director in his personal capacity. The High Court held that the company was not entitled to claim depreciation since it had no dominion over the vehicle and even the beneficial ownership did not vest with the company. This is a case where the assessee sought to claim personal expenses of the director as business expenses, which is an indicator of low ethical quotient. Similar disallowance was made by the Madhya Pradesh High Court in *Bhilai Motors v. CIT (1987) 167 ITR 147*, where motor cars belonging to the assessee firm were used by its partners for personal purposes.

The concept of mutuality means that the contributors and the beneficiaries are identical. Since one cannot make a profit by dealing with oneself, there is no taxable profit involved wherever such concept applies. This concept has however been misused in many cases to avoid tax liability. In *CIT v. Trivandrum Club (2006) 153 Taxman 481*, the Kerala High Court observed that the doctrine of mutuality would not apply in a case where the marriage hall was being rented out to non-members by making them temporary members only for the purpose of letting out the marriage hall and the amounts received from the non-members formed part of the income of the assessee-club. In this case, the Court has corrected the negative ethical factor brought in by the assessee.

In *CIT v. A.N. Naik Associates (2004) 136 Taxman 107*, the Bombay High Court observed that the word "otherwise" in section 45(4) takes into its sweep not only cases of dissolution but also cases of subsisting partners of a partnership, transferring assets in favour of retiring partners. When an asset is transferred to a retiring partner, such transfer falls within the expression "otherwise" and the rights of the subsisting partners in that asset of the firm are extinguished. Therefore, there is clearly a transfer and capital gains tax is attracted. In this case, the High Court applied the "mischief rule" about interpretation of Statutes and pointed out that the idea behind the introduction of section 45(4) was to plug in the loophole and block the escape route through the medium of the firm.

It is significant to note that if the tax payers standard of tax ethics goes up, it would drastically reduce the spate of litigations, of the nature described above, pending in various judicial forums. In fact, such was the large number of tax-related litigations pending with the Courts that the Government decided to create a separate appellate forum for tax related issues known as National Tax Tribunal so as to expedite the judicial process.

14.4.5 Government's role in strengthening ethical standards of the tax payer

The most important factor which would increase the ethical quotient of the tax payer is the increase in the level of trust reposed by the tax payer on the Government. If the tax payer is convinced that the tax he pays is put to productive use in the economy, of which he is an

important part, his compliance with tax laws would go up substantially.

Further, reduction in the rates of tax would also ensure more compliance, since high rates of taxes act as a deterrent to the tax payer from disclosing his full income. It may be noted that keeping this factor in mind, the rates of income-tax have been reduced and exemption limits have been increased recently (Budget 2005). Even the excise duty and customs duty have been reduced considerably in the last few years. This has improved compliance and increased tax revenue substantially. The Finance Minister, Mr. P. Chidambaram, has acknowledged the same recently and promised further reduction of rates if compliance is further improved.

The tax system in India is generally perceived to be complex and difficult to understand. Often, these complexities force the assessees to adopt unethical means for avoiding taxes. This may be done with the intention of evading tax or merely to escape the tiresome, difficult and exhaustive process of computing correct tax liability. This issue has been a cause of great concern for the Government in the last few years. Therefore, the Government is contemplating to introduce a new legislation for direct taxes which is expected to be very simple and tax-payer friendly. Further, it may be noted that it is with this objective that the Government has already introduced self-assessment procedure in Excise and done away with statutory excise records.

The ethics of levy of taxes by the Government can be measured by the relationship between outlays and the quality of outcomes. In fact, the Finance Minister, Mr. P. Chidambaram, in his budget speech, has laid emphasis on "quality of outcome" of the various social sector programmes, which is very much necessary for building confidence amongst the tax payers. The following is the relevant extract of his budget speech (Budget 2006)-

"Government has shifted the emphasis from sheer 'quantity' to the 'quality' of the outcome of the various social sector programmes. To ensure value for public expenditure, an Outcome Budget was presented on August 25, 2005. Government intends to present a Performance Budget on the first Outcome Budget before the end of the Budget Session. The Outcome Budget for 2006-07 will be placed before this House by March 17, 2006. This new approach underscores our resolve to ensure that the intended services in the right quantity and quality are delivered to the aam admi."

It would improve the tax payer's standards of ethics if they are convinced of the positive outcome generated by way of effective utilization of their hard earned money which they pay as tax. Therefore, it is not only the extent of allocation to social sectors and infrastructure development which is important, but it is also the "quality of outcome" of such allocation which can go a long way in increasing the tax payer's ethical standards. In Budget, 2006, substantial allocation has been made to the social sectors, especially those of eight "flagship

programs" which are concerned with universal education, mid-day meal, drinking water, rural sanitation, rural health care, integrated maternity welfare and child development and the massive rural employment guarantee scheme. These form the basic ingredients for raising the quality of life and attaining a higher level of human development and combined with the other components of the overall Bharat Nirman (National Reconstruction) framework, are bound to lead to a well integrated and mutually harmonious social order. Since Budget 2006 has placed emphasis on strict monitoring of outcome and performance, it is hoped that the outlays would translate into positive "outcomes", which would effectively fulfill the moral responsibility of the tax collector and increase the ethical standards of the tax payer.

Note: This discussion relating to ethics in taxation takes into account both direct and indirect taxes.

Self-examination questions

1. Explain briefly the concept of tax planning.
2. Distinguish between diversion of income and application of income, giving examples.
3. Explain the distinction between tax planning and tax avoidance.
4. Discuss the methods of tax planning.
5. Explain the tax effect of retrospective legislation with the aid of a case law.
6. Write short notes on the following in the context of tax planning.-
   (a) Doctrine of Precedence
   (b) Doctrine of form and substance
7. Discuss the tax planning considerations in respect of salary income.
8. What are the tax planning considerations in relation to business?
9. What are the tax planning considerations governing the following decisions -
   (i) Make or buy
   (ii) Own or lease
   (iii) Retain or replace.
10. Discuss briefly the concept of ethics in taxation.
11. Mr. Gavaskar sought voluntary retirement from a Government of India Undertaking and received compensation of Rs.40 lakhs on 31st January, 2010. He is planning to use the

money as capital for a business dealership in electronic goods. The manufacturer of the product requires a security deposit of Rs.15 lakh, which would carry interest at 8% p.a. Gavaskar's wife is a graduate and has worked as marketing manager in a multinational company for 15 years. She now looks for a change in employment. She is willing to join her husband in running the business. She expects an annual income of Rs.3 lakh. Mr. Gavaskar would like to draw a monthly remuneration of Rs.40,000 and also interest @10% p.a. on his capital in the business. Mr. Gavaskar has approached you for a tax efficient structure of the business.

Discuss the various issues, which are required to be considered for formulating your advice. Computation of income or tax liability is not required.

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

Answers

11. The selection of the form of organisation to carry on any business activity is essential in view of the differential tax rates prescribed under the Income-tax Act, 1961 and specific concessions and deductions available under the Act in respect of different entities. For the purpose of formulating advice as to the tax efficient structure of the business, it is necessary for the tax consultant to consider the following issues:

1. In the case of sole proprietary concern, interest on capital and remuneration paid to the proprietor is not allowable as deduction under section 37(1) as the expenditure is of personal nature. On the other hand, in the case of partnership firm, both interest on capital and remuneration payable to partners are allowable under section 37(1) subject to the conditions and limits laid down in section 40(b). Remuneration and interest should be authorised by the instrument of partnership and paid in accordance with such instrument. Interest to partners can be allowed up to 12% on simple interest basis, while the limit for allowability of partners' remuneration is based on book profit under section 40(b).

2. Partner's share in the profits of firm is not taxed in the hands of the partners by virtue of section 10(2A).

3. If a proprietary concern is formed, the salary of Mrs. Gavaskar shall be allowed as deduction under section 37(1).

4. The possibility of invoking section 40A(2) cannot be ruled out as salary is payable to a relative, who is an interested person within the meaning of section 40A(2). However, it can be argued successfully that salary of Rs.3 lakh is justified in view of her long experience as marketing manager of a multinational company and the fair market value of services to be rendered by her to the concern.

5. An issue arises as to whether remuneration of Mrs. Gavaskar would be includible in the total income of Mr. Gavaskar. Under section 64(1)(ii), remuneration of the spouse of an individual working in a concern in which the individual is having a substantial interest shall be included in the total income of the individual. However, the clubbing provision does not apply if the spouse possesses technical or professional qualifications and the income is solely attributable to the application of his or her technical or professional knowledge and experience. Further, technical or professional qualifications do not necessarily mean the qualifications obtained by degree or diploma of any recognized body *[Batta Kalyani vs. CIT (1985) 154 ITR 0059 (AP)]* The experience of Mrs. Gavaskar as a marketing manager in a multinational company for 15 years may reasonably be considered as a professional qualification for this purpose.

6. If Mrs. Gavaskar joins the proprietory concern of her husband as employee, remuneration of Rs.3 lakh shall be taxed in her hands under the head "salary".

7. If she joins as partner in the business, remuneration shall be taxed in her hand as business income under section 28 to the extent such remuneration is allowed in the hands of the firm under section 40(b).

8. The tax rate applicable to an individual depends on the level of his/her income. The rate of tax in the highest tax slab (i.e. above Rs.5,00,000) is 30%; the tax rate for a partnership firm is 30%. Education cess@2% and secondary and higher education cess@1% is attracted in both cases.

12. This issue came up for consideration before the Allahabad High Court in *Jit & Pal X-Rays (P.) Ltd. v. CIT (2004) 134 Taxman 62 (All)***.** The Allahabad High Court observed that the overriding charge which had been created in favour of the wife of the sole-proprietor was an integral part of the sale deed by which the going concern was transferred to the

assessee. The obligation, therefore, was attached to the very source of income i.e. the going concern transferred to the assessee by the sale deed. The sale deed also specifically mentioned that the amount in question was charged on the net profits of the assessee-company and the assessee-company had accepted that obligation as a condition of purchase of the going concern. Hence, it is clearly a case of diversion of income by an overriding charge and not a mere application of income.