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Unit 1 Introduction to Direct Tax

Learning Objectives

1. Understand the basic concept and definition of direct tax within the framework of the Indian taxation system.

2. Identify the key differences between direct and indirect taxes and their respective implications.

3. Analyze the importance of direct taxes in national economic development and revenue generation.

4. Explain the constitutional provisions and legal framework governing direct taxation in India.

5. Recognize the different types of direct taxes levied in India, including income tax, corporate tax, and capital gains tax.

6. Comprehend the principles of tax incidence, tax shifting, and tax burden as applied to direct taxes.

7. Explore the historical evolution and reforms of direct tax laws in India.

8. Examine the role and functions of the Central Board of Direct Taxes (CBDT) in the administration of tax laws.

9. Develop a foundational understanding to compute and assess basic direct tax liabilities of individuals and entities.

Content

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1.0 Introductory Caselet

Title: “The Curious Case of Mr. Arjun’s Tax Bill That Keeps Getting Bigger”

A 35-year-old software engineer, Mr. Arjun Mehta who works and lives in Bengaluru recently got a letter from Income Tax Department. Arjun had been freelancing for clients in India and abroad over the past few years, alongside working full time with a multinational IT firm. His total income had been increasing slowly over the years, yet he kept filing returns reporting only salary.

The Central Board of Direct Taxes (CBDT) this year detected variations in the income he had declared and his bank transactions. The notice demonstrates a substantial mismatch between the cash deposited in his bank account and the income declared under the Income Tax Act, 1961. Unwitting of the consequences of failing to disclose all sources of earning, Arjun approached an income-tax consultant. Under India’s direct tax system, you are taxed as an individual not just on your salary, but on the total of what you have earned elsewhere — that includes freelance earnings and foreign remittances, the consultant explained.

What made Arjun’s case worse was that he had not kept track of his freelance payment or gone for deductions under the relevant sections. His ignorance about the direct tax provisions like, which are covered under total income, what is tax slab and types of deductions that can be availed—made him fall into a trap of – ‘tax evasion’ and penalty under the Income Tax Act.

While Arjun while down with the consultant revising his return and drawing up replies to the notice, he found himself beginning to introspect about taxes, their role in governance and how tax compliance was so critical for an economy on a growth trajectory.

Critical Thinking Question

Explain the relevance for an individual taxpayer of knowing the application and limits of direct tax in India as illustrated in Arjun’s case, with reference to transparency and keeping record?

1.1 Concept of Direct Tax

1.1.1 Definition and Characteristics of Direct Tax

A direct tax is a kind of bulk or main overall tax which has the quality that the full amount paid falls eventually on to only one or another individual. Unlike indirect taxes like GST, the incidence of direct tax cannot be passed on to someone else. The person who is liable for the tax and the burden of taxation fall on the same individual or body.

Key Characteristics of Direct Tax:

Personal in Nature: Direct taxes are imposed on a person's (or entity's) income, wealth or the use of services and were derived directly from the authority of government to force individuals to pay their debts. The tax may not be transferred to another person. If, for example the man receives a salary or derives income from his business he will pay income tax.

5., pp 165 Non-transference: The burden of direct taxes rests on the same person or persons who pay them. Unlike indirect taxes, like the excise duty or sales tax, direct taxes cannot be charged to others. That makes the burden of direct taxes more visible and quantifiable.

Progressivity: Direct taxes tend to be progressive in nature, particularly with respect to income tax. This is to say that people with more income pay at a higher rate. The justification for this scheme is egalitarian wealth distribution and less income disparity.

Assurances and Transparency : Direct taxes ensure greater transparency and assurance. Taxpayers usually know before the financial year ends, how much tax they are required to pay based on a set of clearly laid out tax slabs, exemptions and deductions. This allows for predictability when planning before taxes.

Elasticity: Direct taxes are more elastic. The tax due from a person or company rises as its income grows. This elasticity also means that the government's revenue increases with the size of the economy.

Administrative Convenience and Accountability: More complex to file direct taxes may be, but they represent a better measure of accountability as opposed to indirect levies. Tax-requiring citizens are also required to report the sources of their income, asset ownership, liabilities and other financial information which supports the government's fiscal planning and monitoring.

Significance of Revenue: In modern economies, the direct taxes constitute an important source of revenue to the government. In India, income tax and corporate tax are major contributors to the central government's revenue, used for expenditure on infrastructure, defense, healthcare and education.

Compliance and Record Maintenance: As the onus is on the individual to calculate and pay tax, there is a large amount of documentation involved including salary slips, investment history and business transfers.

Acceptance of Tax Planning and Tax Avoidance: There is wider acceptance of tax planning in the case of direct taxes as compared to indirect taxes because legal provisions in the former like exemptions, deductions and rebates can be fully utilised for tax planning purposes. But it also paves the way for tax avoidance, so enforcements are still essential.

To sum up, direct taxes are an integral part of contemporary systems of public finance. They ensure equity, reinforce the social and economic policies of a country, are social instruments for redistribution and income regulation.

1.1.2 Comparison: Direct Tax vs Indirect Tax

The distinctions between direct and indirect taxes are elementary to an understanding of all forms of national system of taxation. The two types of taxes 66 differ by how they work, who pays the tax, what is taxed and who is responsible for collecting it.

Here are some big differences between direct and indirect tax:

Definition:

o Direct Tax impinges upon the individual or an organization on income, or wealth, or profit. It is non-transferable.

o Indirect Tax – is a tax on goods and services which may be passed from one person to another (typically the seller to the buyer).

Tax Incidence and Burden:

o Direct Tax: The direct tax is one whose incidence and the impact falls on the same person or entity.

o Indirect taxes are those which the tax payer to the government is not same person who actually bears the burden of it and ultimately shifts much or all of it to others.

Examples:

o Taxes imposed directly: Income Tax, Corporate Tax, Capital Gains Tax, Wealth tax.

o Indirect Taxes: GST, Customs Duty, Excise Duty, VAT.

Progressivity:

o Progressive (higher the income higher the tax rate) direct tax.

o Indirect taxes are usually regressive because they are levied in the same rate to everyone and affect poor people relatively more.

Inflationary Impact:

o Inflationary indirect taxes: the reason that is given is that they raise the cost of goods and services.

o Direct taxes are for the most part non-inflationary as they have no impact on product prices.

Ease of Collection:

o Indirect Taxes Indirect taxes are very easy to collect as it is included in the price and collected there at the point of collection.

o Self assessment, documentation and active participation of the taxpayer are involved in direct taxes.

Effect on Consumption:

o Consumption will be hit as higher prices, caused by the indirect taxes, can discourage spending.

o Income tax affects income available for spending but not specifically commodity prices.

Avoidance and Evasion:

o Direct taxes would have higher evasion as people can hide income.

o Indirect taxes are also difficult to avoid as they are levied at the point of collection.

Impact on Savings and Investment:

o Taxes on income in general may reduce saving and investment if rates are high.

o Indirect taxes have an indirect relationship to saving behaviour, 5.

Transparency:

o The incidence of direct taxes is easier to understand; taxpayers can see what they are paying and why.

o The indirect taxes are included in the prices and very less people among general public about these.

Awareness to this distinction is crucial when considering the social and economic impact of tax policies as well as while making decisions, whether as a taxpayer, policy-maker or academic.

1.1.3 Key Features of Direct Taxation

Direct Taxation and Its Special Features India, as well as other countries have its own style of taxing an Individual or entity under Direct Tax. These characteristics not only determine the nature and size of its targets but also affect its governance, compliance, and scale of economic relevance.keywords>(Translator Profile, Reading Specialist - Data (General and Commercial Public)).

Key Features:

Personal Nature of the Tax:

Direct taxes are generated from the personal income, wealth or activities of an individual or organization. As a result, they are inherently very personal, and every taxpayer must divulge their own unique financial situation and liabilities.

Based on Paying Capacity:

One of the highlights is that direct taxes are levied on the ability-to-pay principle. The wealthier you are and the more money your business takes in, the more you contribute; people who earn less than a specified income amount needn't participate. That is the point of a fair tax system.

Progressivity and Equity:

Direct taxes are usually progressive. The rate of taxation is progressive, rising as income increases; therefore the system is fair and helps to lower the overall income disparity.

Self-Assessment and Declaration:

Taxpayers have a voluntary tax calculation and declaration obligation. This promotes responsibility and fiscal literacy, but also requires a sound regulatory pillar to prevent any form of evasion.

Provision for Deductions and Exemptions:

The income tax act offers a number of deductions (such as under sections 80C to 80U) and exemptions (e.g., the HRA, agricultural income) that help an ordinary taxpayer reduce his/her taxable income legally.

Legal Backing and Governance:

Direct taxation in India is handled by laws such as Income Tax Act, 1961. The Central Board of Direct Taxes (CBDT) formulates policy and ensures its execution.

Yearly Assessment and Filing:

Taxation is direct system and is, generally, on annual basis for Kasumpti. Tax payers are to file returns at the end of every financial year, accounting for their income and tax payable thereon.

Audit and Scrutiny Mechanism:

Tax returns submitted can be chosen to be scrutinized or audited by the tax department in order to verify reported figures. This helps to prevent false statements and encourages compliance.

Administrative Complexity:

Direct taxes are even more complicated than the indirect taxes on account of income segregation, deductions, rebates and exemptions. This has resulted in the expansion of tax consultancy firms.

Tax Deducted at Source (TDS):

TDS is a characteristic where income tax gets deducted at the time of earning itself. Basically Employers, Banks and all type of contractors who are paying to the payee's need to deduct tax for payees.

Integration with PAN and Aadhaar:

In anything else that appears vaguely similar to the above, CT is increasingly marrying technology with direct tax compliance in India. Since PAN is a must for tax filings and linkage of Aadhaar has been made mandatory to check misuse and fraud.

Appeals and Dispute Resolution:

An elaborate appellate procedure is provided under direct tax laws where the taxpayer disagrees to an order of assessment. Appeal can be done to appellate tribunals, High Courts or Supreme Court itself.

All these characteristics combined means that the direct taxes are not only revenue tax but also as instruments of general economic purpose, underlining definite social end and financial accountability.

1.1.4 Examples of Direct Taxes in India (Income Tax, Wealth Tax)

Direct Taxes of India The direct tax system in India is a hierarchical set up with different types of taxes which are levied directly on individuals and companies etc. Two such examples, notable in their history and extent of application are Income Tax and Wealth Tax (though latter has been repealed since 2015). However, knowledge of both is essential to be able to comprehend the growth and extent of direct taxes in India.

Income Tax

The Income Tax is the main source of revenue for the Government of India. It is controlled by the Income Tax Act, 1961 and managed by Department of Revenue under the Ministry of Finance.

Key Aspects of Income Tax:

Chargeability: The income of individuals, HUFs, firms, companies, AOPs (Association of Persons), BOIs (Body of Individuals), local authorities and any other artificial person is taxable in mobile year if it exceeds the maximum amount which is not chargeable to tax.

Tax Slabs and Rates:

o The rates of tax are progressive and they vary depending on the slab of income and status of the taxpayer (individual, senior citizen, firm, company).

o Slab rates apply for individuals, but companies and firms have fixed tax rates.

Sources of Income:

Income is divided into five heads:

o Income from Salaries

o Income from House Property

o Income from Profits and Gains of Business or Profession

o Capital Gains

o Income from Other Sources

Deductions and Exemptions:

The Income Tax Act gives several deductions in sections like 80C (investment in LIC, PPF etc.), 80D (health insurance), 80E (education loan interest) and exemptions like HRA, LTA, agricultural income.

Filing and Compliance:

Every person or thing whose income exceeds the maximum limit, has to file an Income Tax Return (ITR) each year. It is mandatory and if in any case one fails to comply or incorrectly reports the income, penalties are levied.

TDS and Advance Tax:

The concept of Tax Deducted at Source (TDS) and advance tax payment are based on the philosophy to encourage smooth flow of resources by avoiding unnecessary accumulation in terms of revenue.

Assessment and Scrutiny:

Income Tax Department can determine to check or scrutinize tax returns of any people for accuracy. Under the new e-assessment scheme, there are regular or faceless assessments.

Wealth Tax (Abolished in 2015)

The Wealth Tax Act, 1957 was a direct tax on the net wealth of every individual, HUF and company. It was repealed on the twelfth day of May, 2015, in view of it being non-revenue yielding and high revenue leakage. But as an academic and historical subject it is still worth analyzing.

Salient Features of the Wealth Tax Act:

Chargeability:

o There was a wealth tax on Individuals, HUFs and Companies if their net wealth exceeded ₹30 lakhs.

o Net asset value included certain non-performing assets such as land, jewelry, yachts, cash on hand, and cars.

Tax Rate:

o The wealth tax rate was 1% of the value over and above ₹30 lakh.

Valuation and Filing:

o The assets had to be valued as per the rules and regulations. They were to be reported annually.

Exemptions:

o Some assets were exempt (e.g. business use residential property and specific agricultural land).

Reasons for Abolishment:

o Collection cost was more than the actual collection.

o Administratively, it was costly because of problems of valuation and enforcement.

The government has replaced it with a 2% surcharge on the super-rich to make up for lost revenue.

Direct Taxes (By Other Examples Current and Historical):

• Corporate Tax: It is the tax on the net income of companies which operate in India.

• Capital Gains Tax: A tax on the capital gain, or profit, made when an investment is sold.

• STT: An additional tax is on the value of securities traded through a recognized stock exchange.

• Dividend Distribution Tax (DDT) : A tax imposed on Indian companies for making dividend payments to their shareholders (This has been abolished).

• Gift Tax: Formerly independent, now subsumed in the provisions related to income tax (Section 56 of the Income Tax Act).

These are the direct taxes and they contribute together to the countries fiscal health, enabling (/the government) to invest in infrastructure, provide public services as well as financing social systems.

1.1.5 Impact of Direct Tax on Individuals and Businesses

As one of the core components of the tax policy, direct taxes exert extensive effects on economic behavior and financial status of individuals and businesses. Such effects may be found in income distribution, tax compliance costs, production decisions and consumption patterns as well as firm's investment behavior.

Impact on Individuals:

Reduction in Disposable Income:

Taxes such as income tax directly decrease the net take-home pay of the worker. It affects both the personal budget of individual households, their savings and consumption decisions. For example, higher rates of tax may deter reckess spending and promote saving under tax-saving schemes.

Behavioral Change:

The format of direct taxation breeds incentives to plan taxes. People often put money into instruments such as PPF, NPS and ELSS or buy insurance simply because the deduction is available under Section 80C. That's how closely one's financial life is linked to tax policies.

Equity and Social Responsibility:

Progressive taxation rates so that the wealthy pay a higher proportion of their income in tax. This supports the

“…it is based on the principle of vertical equity and substantiates that taxpayers should pay in accordance with their ability to contribute in the development of the country.”

Awareness and Documentation:

The direct taxes make a person to keep accounts of money, know income heads and tell them about their legal acts. This eventually will enhance financial inclusion and encourage culture of compliance.

• Disincentive to Earn More (Some Cases):

In the absence of reasonable exemption limits and logical slabs, some taxpayers could perceive higher income as excessively taxed, leading to evasion, avoidance or constrained incentive to invest in growth.

Impact on Businesses:

Cost of Compliance:

Compliances under Direct Taxes are very costly and time-consuming for the industry, particularly MSMEs. This hiring accountants, overseeing audits, receiving notices of scrutiny and keeping up-to-date with new laws.

Influence on Investment Decisions:

Corporate tax rates and capital gains taxes affect where and how companies invest. Tax breaks, like accelerated depreciation or a research and development deduction, influence what businesses do with their resources.

Impact on Profitability:

Taxes are an erosion of the after tax net income return to shareholders, and the stored equity reinvestment capital. I think that determines your dividend, retained earnings or market value.

Transfer Pricing and International Operations:

Direct Taxation: Transfer pricing, double taxation are the problem areas on direct taxation for the multinational companies. Consistency with the tax treaty, arm's length pricing and BEPS (Base Erosion and Profit Shifting) are all significant issues.

CSR and Tax Deductions:

Some of the CSR expenses under 135 (5) can be written off which attracts business houses to get involved in social developmental activities. In other words, direct taxes also serve as instruments to shape corporate behavior.

Tax Planning and Innovation:

Legislation provisions provide businesses with legitimate means by which to abreast themselves of operations and their tax planning. But aggressive tax planning can slip towards avoidance, which is something tax authorities must remain vigilant about.

Sectoral Impact:

Ceteris paribus, direct tax policy might impact some sectors more than others." For instance, IT and pharma companies may be the beneficiaries of R&D deductions, manufacturing entities could stand to gain from Make-in-India incentives or lower corporate tax rates.

Did You Know?

"The abolition of wealth tax in 2015 was not due to lack of intent to tax the rich, but because the cost of enforcing the law far exceeded the revenue collected. In fact, in its last year, wealth tax contributed less than ₹1,000 crore to the exchequer, making it economically inefficient to administer."

1.2 Historical Background of Direct Taxation in India

1.2.1 Origin and Evolution of Direct Tax in India

Direct tax in India is one of the most ancient forms of taxation. Introduction Direct taxation in India from the times of old monarch to new constitutional monarchy has been a chequered one.

Ancient and Medieval Periods:

• Taxation existed in ancient India since the Vedic period itself. Treatises such as Manusmriti and Arthashastra have mentioned that many aspects of taxation by government were already practiced during this period.

• Taxation at these times was mainly in kind on agricultural produce, land, animals including cattle and trade. In exchange for protection and justice, the king (or state) took taxes as a duty from the subject.

• Taxation During the Mauryan period, the taxation system was normally proportionate and in extent even progressive in parts but Kautilya's maxim was that the tax should be "as a large fish gently draining water from the pond".

Mughal Period:

• The Mughal Empire was one of the most neatly organized systems of revenue in many ways, particularly under a ruler such as Akbar.

• Land revenue was collected on the basis of Zabt and Ain-e-Dahsala, i.e., a regular measurement and classification of land.

• While land revenue tarried, there were other taxes as well: customs duties, trade excises and — now and then — wealth-based taxes.

British Colonial Period:

• THE MODERN DIRECT TAX SYSTEM IN INDIA was also first initiated by the British.

• 1860: To recover the loss of income caused by the Sepoy Mutiny, Sir James Wilson adopted India's first Income Tax Act in 1860.

• It was a provisional measure when first introduced but has been imposed in various forms over the years.

• An enduring Income Tax Act was passed by 1886. Divide the income into various heads, and introduced the concept of assessing officers.

• Over the years, additional Acts such as the Super Tax Act, 1920 and Wealth Tax Act were introduced to augment revenue and capture developments in the economy.

Post-Independence Developments:

• Post-1947, India chose to keep and amend many of the colonial tax laws.

The Income Tax Act of 1961, still in place today (altered by many amendments), was instituted to be a unifying and systematized arrangement for taxing incomes. This Act superseded the Income Tax Act, 1922.

• The Act sought to unify the law, make it comprehensive and in fitting with independent India's vision of its economy.

• Several forms of direct tax have been added since then, including the personal income taxes, capital gains tax, dividend distribution tax and the alternative minimum t ax.

Evolution in the Modern Era:

• The implementation of PAN and permanent account numbers, e-filing & faceless assessments are factors indicating the transition to digitalisation.

• There is a gradual decrease in the corporate tax rate, wealth tax has been abolished and several exemptions have been rationalised, which signals a move towards simplicity and efficiency.

• The Direct Taxes Code (DTC) had been envisaged as a replacement of the Income Tax Act, 1961, but has not been rolled out yet.

This historical path of direct taxation in India shows how it has developed from a feudal exaction to an elaborate codified system for obtaining revenues on the principles of fairness and efficiency.

1.2.2 Important land marks in Indian General Taxation Policy.

1.2.1 Key Milestones in Indian Taxation Policy

History of Indian Taxation The history of Indian taxes can be divided into the following four periods, each contributing to shape the present system of direct taxation in one way or other. These developments are indicative of legal, administrative, and technological changes that aim to render tax collection more efficient, fair and in tune with economic actualities.

Important Milestones:

1860 – Arrival of the First Income Tax Law:

o Founded by Sir James Wilson to make up for the monetary losses incurred after 1857 revolt.

o Levied even on income in excess of ₹200 and agriculture exempted.

o The birth of Modern Direct Taxation.

1886 – Passage of the Permanent Income Tax Act:

o Classified the income as per certain heads.

o Established the basis for subsequent modifications in income tax levied.

1922 – Income Tax Act, 1922:

o Supplied explicit procedural guidelines pertaining to the assessment, collection and appeals.

o Gave more powers to the Income Tax Department.

o Marked a milestone in the direction of centralised rule.

1956 – Establishment of CBDT:

o Established for policy to develop and manage in respect of direct taxes.

o Evolved as the supreme authority responsible for administration and control of direct tax legislations.

1961 – Income Tax Act, 1961:

o Passed as a complete revision of the tax code to supersede the 1922 Act.

o Which still remains as the nucleus of direct taxation in our country.

o Included heads of revenue, deduction, diminution and abatement.

1985 – Adoption of Wealth Tax and Gift Tax (Amendment):

o To provoke a tax on asset not used for productivity and equity accumulation.

o Both were criticized as being too complex and eventually repealed.

1991 – Liberalization and Tax Reforms:

o Launched by the Narasimha Rao Ministry.

o Resulted in setting up of several committees of experts (eg., Raja Chelliah Committee).

o For rationalizing rate/ broadening base/ better compliance.

2004 – FBT and BCTT were introduced Myanmar welcomes Indian rupee as an officially traded foreign currency Yesanax for the above answer.

o "Focused/ Indirect" earnings from employer sponsored benefits or substantial cash payments.

o Eventually repealed as it was administratively complex and had minimal revenue effect.

2014–15 – Wealth Tax has been abolished:

o Replaced by a higher surcharge on the ultra-rich.

o Thought to be better tolerated, simpler to take.

2019 – Reducing the Corporate Tax Rate:

o Scaled down to 22% for existing companies and 15% in the case of new manufacturing companies.

o Intended to boost growth and investment in the economy.

2020 – Direct Tax Vivad se Vishwas Scheme:

o Was introduced to settle tax disputes with less litigation.

o Promoted voluntary compliance and cut the backlog of cases.

2020 and Above – Faceless Assessment and Appeals:

o Signaled a significant structural change in tax governance.

o Sought to minimize human intervention, improve transparency, and discourage corruption.

Each of these transition areas represents a policy change in the direction of simplification, equity, revenue enhancement, or administrative efficiency. They cumulatively illustrate the flexibility and sophistication of the Indian tax system in meeting evolving socio-economic demands.

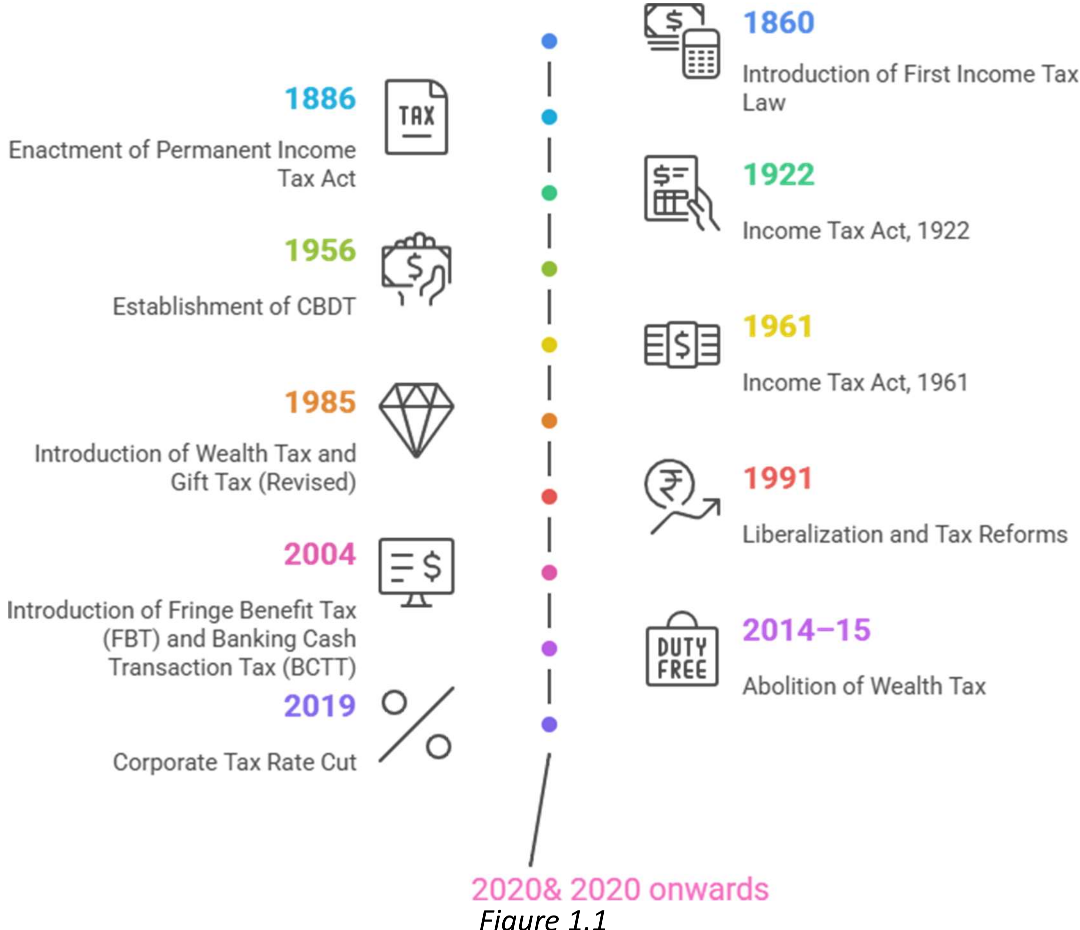

Figure 1.1

1.2.3 Establishment of CBDT

The Central Board of Direct Taxes (CBDT) is the highest policy making body for direct tax in India. It is operating under Department of Revenue of the Ministry of Finance, Government of India. The establishment was a major development in the organization and functioning of direct tax administration.

Historical Context:

• The Central Board of Revenue Act, 1963 provided a statutory basis for the CBDT.

• Before the formation of CBDT, the task of direct tax was under the charge of Central Board of Revenue at Delhi which was working under control and supervisions of Ministry.

The growing scope of taxing power, the diversification of taxable and increase in tax revenues post-independence required a separate organizational set up to handle fiscal policy, law and administration from there on.

Structure of CBDT:

Composition:

o The CBDT is headed by Chairman and consists of six Members.

o There are different portfolios allocated to every member such as legislation, investigation, revenue, income tax and audit and systems.

Functions:

o Policy Drafting: Design policies concerning income tax, corporate tax and other direct taxes.

o Implementation Oversight : Oversees the working of field formations such as income tax departments and investigation winks.

o Administration Coordination: Ensures the appointments, promotions and transfers with in the tax department.

o Budget and Target Setting: Involves monitoring of collection targets and assessing departmental performance.

o Dispute Resolution and Litigation Management: Develops strategies with respect to appeals and litigation in both tribunal conducts.

Technological Initiatives:

o CBDT has successfully launched initiatives such as e-filing of returns, Aadhaar-PAN linkage and faceless assessment.

o The board oversees the gradual updating of tax systems.

International Engagement:

o Participates in negotiations and oversees the effective implementation of DTAA.

o Assist in aligning Indian tax laws with global trends, including BEPS (Base Erosion and Profit Shifting).

Issuance of Circulars and Clarifications:

o Offers official clarifications and guidance to fill in the gaps of tax legislation by way of circulars and notices.

Investigation and Enforcement:

o Liaisons with the Directorate of Income Tax (Investigation) and Directorate of Criminal Investigation.

o It is an important tool to fight tax evasion, black money and benami transactions.

Establishment CBDT institutionalised policy for tax in India and it has also disassociated paedagogics of taxes with the hydraulic rule of taxes. It still has the important tasks of bringing in economic reforms, dovetailing Indian tax policies with its development agenda and global best practices.

1.2.4 Major Changes in Direct Tax Structure

Since independence, the Indian direct tax system has been significantly reformed to counter complexity, inequity and inefficiency. The motivation for this reform were frequently economic crises, international trends and the necessity to stimulate, comply or tax. The aim has always been to simplify the tax system, broaden the tax base and lower rates while improving administration.

Main Reforms and Key Phases, and Measures:

Reform Era Post-1991 Economic Crisis:

o The BOP crisis in 1991 required structural economic adjustments.

o Taxation system was a thrust area under New Economic Policy.

o 1991 A Tax Reforms Committee was set up in 1991 under Dr. Raja J. Chelliah which led to significant alterations in the direct tax system.

Reduction of Tax Rates:

o The most significant change post-1991 was the lowering of individual and corporate tax rates.

o Taxation on personal income was reformed by slashing down the high marginal rates of up to 97.5% to more reasonable levels that taxpayers would not mind to pay and, also, to stimulate compliance and investment.

Broadening of Tax Base:

o Repeal of many exemptions and deductions to broaden the tax base.

o Tax base was increased by various steps like Compulsory PAN, TDS/TCS compliance, bank account links with tax identity.

7.1 Introduce MAT for PSEs/Statutory Corporations with receipts of Rs 50 Crore and above:

o There are many profitable firms which paid little or no taxes with exemptions and incentives.

o In order to counter this the minimum alternate tax was introduced 1996-97, which mandated companies to pay at least a percentage of profits recorded in the books as tax.

TDS Extension:

o TDS had emerged as an important instrument to meet the requirement of ‘real time’ collection of taxes and compiling information relating to financial transactions.

o This was broadened and it also included compensation, rent, interest professional fees and contract payments.

Voluntary Disclosure and Settlement Schemes:

o For reducing litigation and to bring undisclosed income in the tax map.dictions' famous disclosure schemes were introduced like:

♣ Voluntary Disclosure of Income Scheme (VDIS), 1997 ♣ Tax Treatment of Global Depository Receipts (GDR) HOLDERS, 2000.

♣ Income Declaration Scheme (IDS), 2016

♣ Vivad se Vishwas Scheme, 2020

Digitalization and E-Governance:

o The transition to e-filing of returns also e-verification, e-assessments and faceless appeals was an important focus point.

o TRACES, TIN-NSDL and newly launched Income Tax Portal etc. were the platforms which facilitated tax administration.

Corporate Tax Rationalization (2019):

o In a significant push for reform, the corporate tax rate was brought down to 22 per cent for existing companies and

15% for new manufacturing firms.

o The shift was intended to enhance international competitiveness and FDI.

Abolition of Wealth Tax (2015):

o The Wealth Tax Act, found to be obsolete and ineffective, was removed.

o Instead, higher surtaxes were applied to the ultra-rich: They were easier to collect and brought in more money.

Faceless Assessment and Appeals (From 2020):

o Launched to minimize corruption, bring in transparency, and do away with human interface between tax payers/ assessees and officials.

o Cases, summons and judgment are all served online with each geographical location dealing with matters.

GAAR (General Anti-Avoidance Rules):

o Established in 2017 to fight against aggressive tax planning and make the tax payment take place where economic activity happens.

o GAAR gives tax administrators the authority to deny tax benefits in respect of impermissible avoidance arrangements.

International Compliance and BEPS Implementation:

o India has initiated measures to adopt BEPS (Base Erosion and Profit Shifting) guidelines of OECD.

o Features: country by country reporting, compulsory notifications and tax treaty changes.

Promoting Ease of Doing Business:

o To provide a hassle-free experience to taxpayers several measures such as pre-filled tax returns, taxpayer charter and quick processing of refunds have been brought in.

These changes have made a substantial contribution to increasing compliance, reducing evasion, modernizing administration and making the tax system fairer. But there are still challenges in litigation, arbitration in dispute resolution and in mainstreaming informal sector taxpayers.

1.2.5 Functions Performed by Different Committees (e.g., Raja Chelliah Committee)

There have been expert committees and commissions, set up by the Government of India over the years to study as well as recommend tax reforms. These committees have defined the contours of direct tax policy even as they have remained responsive to dynamic economic circumstances and international best practices.

Prominent Committees and Their Contributions:

Raja Chelliah Committee (1991–1993)

Full Name Tax Reforms Committee headed by Dr. Raja J. Chelliah

Objective: To suggest a holistic reform of the tax structure in India, in the wake of liberalisation and structural reforms subsequent to 1991 crisis.

Key Recommendations:

• Cutting High Rates of Taxation: Recommended simplification of tax rates on individual and corporate taxpayers at sensible levels in order to foster compliance.

• Widening of the Tax Base: Argued for elimination of exemptions and concessions which have given way to erosion in tax base.

• Strengthening TDS Mechanism: Suggested strengthening of the TDS mechanism and its coverage, thereby increasing collection in real time.

• Introducing MAT: Opened the door for introduction of Minimum Alternate Tax to tax zero-tax companies.

• Better Management: Pushed for upgradation of the tax department and better use of IT systems.

• Streamlining and Codification: Recommended the streamlining of tax laws to minimize litigation and complaints by taxpayers.

The recommendations of the Chelliah Committee were justified on a number of grounds – they underpinned India's ambitious programme of modernizing its tax system and contributed to it becoming fairer and more efficient.

Kelkar Committee (2002) Head: Dr. Vijay L. Kelkar

Goal: To keep up the good work on tax reform in income taxes as well as GST.

Key Recommendations:

• Extension of PAN Coverage: Suggested to extend coverage of PAN to include more financial transactions to check tax evasion.

• Tax-Based Distortions Eliminated: Recommended reduction of the deductions that result in different treatment for taxpayers.

• Taxpayer Services: Moved in favor of taxpayer-oriented services, transparent administration and speedy refunds.

• E-governance Initiatives: Proposed usage of technology to facilitate compliance and minimise interface with tax authorities.

Not all the recommendations were adopted but many shaped subsequent reform, especially regarding digitalization and taxpayer service.

Shome Committee (2012)

Chairperson: Dr. Parthasarathi Shome

Focus Area: Revisited the contentious provisions for retrospective taxation and GAAR.

Key Contributions:

• Implementation of GAAR: Suggested that implementation of GAAR be postponed so that investors are clear and certain about the approach.

• Retrospective Amendments: In the opinion of an overwhelming majority, retrospective amendments should be made except in rare case of abuse.

• Tax Certainty: Highlighted the importance of predictability and stability in tax policy to stimulate investment.

Justice Easwar Committee (2016)

Objective: Simplification of Income Tax Act and taxpayer friendly administration.

Key Suggestions:

• ”Reduc[ing] unnecessary litigation where contract language is vague or ambiguous.”

• Thinking twice about imposing penalties and scaling back on harsh punishments for minor offenses.

• Enhancing dialogue between taxpayers and the department.

Additional Contributions of Committees:

• DTAA and Transfer Pricing Reforms: Various committees have been looking into the policy measures to improve India's treaty regime and movement against double taxation and profit shifting.

• Digital Economy and Taxation: Over the past few years, committees have been examining taxation issues concerning digital economy and e-commerce resulting in proposal for equalization levy and for tax on digital revenue.

Such committees have had major influence on the policy and administrative structures of India’s direct taxes. Their perspectives, especially in harmonizing Indian structures with international best practices and promoting compliance continue to shape tax administration today.

1.3 Significance and Economic Role

1.3.1 Revenue Generation for the Government

Tax is the basis of a government’s fiscal structure as it provides the major part of revenue, which is needed to offset public spending. Income tax, corporation tax and capital gains tax are the major part of the total government revenue. These resources pay for the operations of democratic structures and implementation of development programmes.

Direct taxes provide the government with funds to finance:

• Public Investments: Roads, railways airports and power lines requires consistent funding long-term finance available mainly through direct taxes.

• Social Welfare Programmes: A major portion of the government expenditure on health, education, rural development, food subsidies and employment programmes (such as MGNREGA) is financed by tax revenue.

• Administrative Tinkerings: Public Servants, police-military and judiciary get paid from revenue harvested as taxation.

• Service of Interest Payment and Debt: The tax amount received directly helps to service the country's debt by payment of interest as well as supporting various measures taken to reduce fiscal deficit.

Furthermore, direct taxes enable non-inflationary funding. Direct taxes remove surplus from those who have additional income to pay and keep the prices stable, unlike printing money which causes inflation.

Some other revenue-generating positions are:

• Predictability and Stability: Properly administered direct tax system could guarantee a stable flow of resources to the government for planning purposes.

• Elasticity: The tax base expands with the economy and that collected from direct tax is proportionate to the growth of an economy which makes its source sustainable in long-run.

• De-centralised revenue: With devolution of tax, the Centre shares part of direct taxes with states already for cooperative federalism.

Basically, the efficiency and effectiveness of direct tax payers capacity in determining government's ability to fulfill its constitutional, developmental and welfare functions.

1.3.2 Redistribution of Income and Wealth

Direct taxation is an important instrument to achieve income and wealth redistribution, such as in a country like India with high economic gap. By imposing progressive rates of tax, direct taxes enable all people and corporates to contribute to the public exchequer based on their affordability.

Key aspects of redistribution include:

• Progressive Tax: The tax system where the higher income earners are subjected to higher taxes. This creates an effective tax, which is a decreasing function of post-tax income inequality.

Wealth-Based Taxes 11 Even though the wealth tax was repealed in 2015, the luxury taxes and higher surcharges on high income earners are still part of the redistribution process.

• Corporate Social Responsibility (CSR) :CSR, made mandatory by the Companies Act 2013, complements tax policy and is a means to ensure indirect equitable distribution of wealth that requires companies earning above a specified net worth in profit to spend on society.

Redistribution occurs in two stages:

Collection Taxes are collected from high earners driving an ECONOMY, INCOME, and CORPORATIONS/BUSINESSES.

Expenditure Stage: Revenue is spent on subsides, education, health services, rural development and welfare programs specifically for lower income or weaker section of society.

Other supporting mechanisms include:

• Refundable Tax Credits and Rebates: Available for low-income taxpayers to shelter their responsibility.

• Patterns of Public Expenditure: Targeting towards low income states or backward regions is only feasible due to resources raised by direct taxation.

Tax-based redistribution, which causes the reduction of inequality, needs to be balanced very carefully. Excessive taxation can stifle investment and cause evasion. Hence, tax policy should be based on fairness without the loss of economic entrapreneurship.

1.3.3 Promoting Equity and Social Justice

The equity aspect of taxation concerns fairness in the allocation of the tax burden. Taxes: Taxes are one of the most effective ways for the state to advance social justice, and to prevent economic inequality from creating social inequity or marginalization.

Types of Equity:

• Graduated (Progressive) Tax: A tax structure whereby those with a greater ability to pay (i.e., higher income or wealth) contribute a higher portion of tax revenues. Principles of progressive income tax rates, which is practiced in India.

• Horizontal Equity: Implies that those with equal income or ability to pay should be taxed equally. The tax system is designed to treat equals the same and nobody differently.

How Direct Tax Promotes Equity:

Progressive Taxation: People who earn more are put in higher tax brackets and those with income less than the taxable limit are not taxed, thus linking tax burden with ability to pay.

Deductions/Exemptions: Citizens get deductions on what they spend in education, health insurance, housing etc. these support socially desirable outcomes.

Equal Opportunity: Direct taxes are a form of enhanced taxation, and is used to offer free education and health care services along with sanitation for the under privileged people and hence equality of opportunity.

Facilitating Inclusive Growth: Government programs for food security, affordable housing, rural employment and skill development are backed by tax policy.

The Indian Constitution guides the government through its Directive Principles of State Policy to reduce income disparities. These values of the Constitution get reflected in its direct tax policies.

In addition, some indirect tools to promote equity are incorporated via the tax system:

• Capital Gains Tax: Forcing those making money off the sale of assets to share gains with the government.

• Provisions of Inheritance and Gift Taxes: Although almost fully abolished, the debates over their revival underscore the power of direct taxes to curb wealth inequality across generations.

It is in this way that just taxes help create a fairer society – where everyone gives according to their means to the common good, and where public funds are employed to bolster those at greatest disadvantage.

1.3.4 Influence on Investment and Consumption

Tax is a huge driver of investment and spending by both businesses and consumers. Direct taxes can be used to incentivize or dis-incentivise certain financial behaviours, by changing disposable income and after-tax returns.

Influence on Investment:

Tax Incentives for Investment:

o Many Sections, such as 80C, 80D and 10(38), provide deductions or exemptions for investments in specific types of investment products.

o Such tax concessions serve as motives for people to take out insurance, pension fund, mutual fund and national savings devices.

Corporate Investment Decisions:

o Reduced corporate taxes and capital depreciation incentives affect the magnitude and composition of private investment.

o The investment in focused industries is stimulated by SEZs and sectoral tax holidays.

Capital Gains Tax:

o Gains on short-term and long-term capital gains on real estate, stock and other investments have tax implications.

o Taxation considerations have a direct impact on market behavior, as investors are planning times in which they will hold an asset.

MAT and Tax Planning:

o Big corporations, while planning prefer MAT and loss and depreciation treatment.

Influence on Consumption:

Reduction in Disposable Income:

o Income tax decreases the income of people which they can spend on consumption causing decreasing in demand for luxuries.

Tax Incentives and Consumer Behavior:

o Tax advantages on particular expenditures (for example, education loans, home financing)promote consumers to spend in specific industries.

Savings vs. Consumption:

o Tax shelters frequently divert potential consumption into long-term saving vehicles, which may reduce the level of current consumption but increase investment.

Behavioral Economics and Nudging:

o The government "nudges" citizens in certain socially desirable directions by altering the tax code—e.g., incentivizing renewable energy w/ tax refunds on solar installations.

Indirect Impact Through Business Decisions:

o High corporate tax can force corporations to reduce their level of production or postpone expansion that subsequently affect employment and the demand by consumer.

Where a reasonable tax incentive is designed to encourage investment and productive consumption, over-taxation or difficult-to-understand incentives can create economic distortion. Therefore, policymakers should frame the direct tax system in a manner that balances between revenue requirements and growth imperatives.

1.3.5 Tax system as an Instrument of Economic Policy

Direct tax is not just a mode of revenue collection, it is also an instrument of economic policy. By varying tax rates, structures and incentives the government can affect a host of macroeconomic variables--investment, consumption, employment, inflation and income distribution.

An efficient direct tax policy is therefore, the main instrument to mould the economic future of a country towards long-term developmental objectives.

Fiscal Policy and Stabilization

Direct taxes are an essential component of fiscal policy, that is to say the choices government in respect of taxation and expenditure. 3) Direct Taxation: The Government can directly regulate effective demand and stabilize the economy by varying rates of direct taxes :

•When the economy is in a period of inflation, increasing direct tax rates can decrease disposable income and demand, helping to put the brakes on rising prices.

• When an economy is in a recession, cutting tax rates can spur demand by lifting disposable income and raising consumption and business investment.

This counter-cyclical aspect of direct tax policy is vital for stability in the economy and to avoid excessive volatility in growth.

Promoting Savings and Capital Formation

These incentives are to direct private savings into productive investments under direct taxes.

• You get deductions underSection 80C,80D, 80E and various other sections which act as incentives for investing in government schemes like Public Provident Fund (PPF), National Savings Certificates (NSC) and pension funds.

• For businesses, amortization and R&D research deductions as well as incentives for capital investment

induce plowing back of the profits, which results in capital formation and growth.

Direct tax policy By encouraging savings and investment activity, this contributes to the build-up of the nation's capital stock and long- term productive potential.

Attracting Domestic and Foreign Investment

There have been a number of changes over time to make India’s tax policy more investor-friendly, especially in relation to:

• Lowering the corporate tax rate to enhance competitiveness.

• Simple and consistent tax treatment of dividends, capital gains, and repatriation of profits.

• Bilateral tax treaties and advance pricing agreements (APAs) for multinationals to provide predictability and restrict double taxation.

These steps make the Indian tax climate more transparent and globally-oriented, ushering in for both countries.

FDI and domestic capital formation.

Encouraging Sectoral Growth

Government fosters certain industries or sectors it deems important for economic and social progress via direct tax encouragement:- 6 Oil & Gas Example.

• There is tax holidays and lower compliance threshold for start-ups and MSMEs.

• Targeted exemptions and deductions for infrastructure, renewable energy and affordable housing.

• Rural and agriculture development is encouraged indirectly by tax exempt status of agricultural income.

These types of sector-specific tax measures are important instruments to steer the structural change of the economy.

Reducing Income Inequality

As it follows from the previous sections, direct taxes are highly redistributive and thus inclusive in their nature. Government taxes the rich at a higher rate and on the other hand it gives out to welfare programs for those who are less privileged, so that even when inequality is uncontrolled it can be reduced.

Formalization of the Economy

The formalization of firms and jobs has a role which can be encouraged by direct tax policies.

• Tying benefits to registration and tax.

• Tracking of financial data via digital reporting systems such as PAN, TDS, e-filing-actions.

• Offering simplified tax systems for small taxpayers (e.g., presumptive taxation).

This lifts the recorded level of economic activity, improves transparency and increases the long-term growth potential.

Macroeconomic Management and Planning

Direct tax revenues are non-inflationary, i.e., do not lead to money supply growth. And it enables the government to fund fiscal deficits without having to borrow inflationary or print money.

Moreover, predictable revenue made available through direct taxes aids in planning and budgeting, intergenerational equity, and maintaining long-term fiscal sustainability.

Incentivizing Behavioral Change

Direct taxes can be structured to subtly push taxpayers toward socially or economically desirable choices. Examples include:

• Depreciation of green investments or energy-efficient home improvements.

• Corporate tax breaks for hiring from disadvantaged backgrounds.

• Section 80G: This provision, which allows for deductions on account of contributions made to an agency or trust registered under the act as a charitable institution and in certain cases

to government-affiliated institutions, acts to dovetail the tax-incentive system for individuals with national policy.

In conclusion, direct tax is a weapon of the economic governance. Whether it is to spur growth, stabilize the economy, promote equity or create a longer-term competitive and structural change, how we design and implement direct tax policy shapes our economic course as a nation.

Figure 1.2

Knowledge Check: Influence on Investment and Consumption (1.3.4) Choose the correct answer for each question.

1. Which section provides tax deductions for investments in instruments like PPF and ELSS?

a) 80D

b) 80C

c) 10(38)

d) 24(b)

2. What impact does capital gains tax have on investor behavior?

a) Encourages early sale

b) No impact

c) Encourages long-term holding

d) Discourages savings

3. Tax on income reduces:

a) Savings

b) Disposable income

c) Bank loans

d) Debt

4. Higher corporate tax rates may discourage:

a) Consumption

b) Savings

c) Foreign investment

d) Indirect tax

5. Which tax provision incentivizes health insurance investment?

a) 80C

b) 10(10D)

c) 80E

d) 80D

1.4 Summary

- ❖ Direct tax is the tax which is levied directly on people and organizations that cannot be transferred to others.
- ❖ It contains the tax of income, corporate and capital gains as well as wealth tax but for now wealth tax is removed.
- ❖ The Indian direct tax system has its roots in the British era with the enactment of the first Income Tax Act, 1860.
- ❖ The direct tax law in India, owes its origin to the Income Tax Act, 1961.
- ❖ The Central Board of Direct Taxes (CBDT) is the supreme decision-making and administrative body in respect of direct taxes.
- ❖ ϖ Key reforms are rationalization of rates, broadening the base and implementing digitalisation and faceless assessment.
- ❖ Direct tax is a major source of income to the government and it supports public expenditure on infrastructure, welfare and administration.
- ❖ It is an important instrument in the redistribution of income and wealth for maintaining social justice, by using progressive form of taxes.
- ❖ The investment and consumption decisions are affected by the tax policies in terms of changes in disposable income and special incentives.
    - ¬ Direct Tax helps in achieving economic policy objectives like stabilizing economic growth, promoting inclusive development and formalization of the economy.
- ❖ Many committees, including Raja Chelliah Committee have had major impact on India's tax reform agenda.
- ❖ Direct tax is not only a revenue instrument but also a sociaij economic tool for achieving equity, justice and sustainable development.

1.5 Key Terms

1. Direct Tax – A tax that is paid by the person or entity on which it is imposed.
2. Income Tax – A tax placed on the income of individuals and entities.
3. Corporate Tax – A tax on the income of corporations.
4. CBDTCentral Board of Direct Taxes: The body which regulates direct tax matters under the Ministry of Finance.
5. Progressive Taxation – It is a tax system where the rate of tax increases as income rises.
6. TDS – Tax Deducted at Source; a tool to apprehand tax on source of income.
7. Tax Base – The value or income subject to taxation.
8. Minimum Alternate Tax(MAT) – A minimum tax which is to be paid by companies that have a zero or low profit, because of exemptions.
9. Faceless Assessment- An assessment without any human interface between the taxpayer and the assessing officer.
10. Tax Planning – Arranging your financial affairs to be as tax-efficient as possible.

11. Tax Evasion – The act of sidestepping taxes that are rightfully owed.
12. Double Taxation Avoidance Agreement (DTAA) – The double taxation treaties embodying the agreement between countries concerning identical income being taxed in two nations.

1.6 Descriptive Questions

1. Define direct tax. Describe its important characteristics citing examples.
2. Distinguish between direct and indirect taxes with reference to incidence, impact and administration.
3. Discuss the historical development of direct taxation in India from the pre-independence period to date.
4. Explain the role and functioning of CBDT.
5. What are the key reforms in the direct tax regime in India since 1991?
6. Account for the revenue and distributional implications of direct taxes in India.
7. Explain how direct taxes affect investment and the pattern of consumption in the economy.
8. How far does direct taxation is effective as an instrument of economic efficiency and social justice?

1.7 References

1. Income Tax Act, 1961
2. Ministry of Finance, Government of India – Annual Budget Documents
3. Reports of the Raja Chelliah Committee on Tax Reforms (1991–1993)
4. CBDT Annual Reports and Circulars
5. Kelkar Committee Report on Tax Reforms (2002)
6. Indian Economic Survey (Various Years)

Answer Key to Knowledge Check (from 1.3.4)

1. b) 80C
2. c) Encourages long-term holding
3. b) Disposable income

4. c) Foreign investment

5. d) 80D

1.8 Case Study

Title: Tax Compliance Problems in a Growing Company -The "Syntrex Solutions" case Introduction and context of the study

Syntrex Solutions is a mid-sized IT company based inPune India.founded in 2016. Started off as a start-up operation with less than 10 employees, within the first five years it had expanded to employing 150 staff and customers in India, UK and US. The company offers business software and cloud data storage services.

Even as Syntrex expanded, it had little sense of tax. Its founders were mostly technocrats who knew nothing about the changing direct tax laws. The major focus was on product development expansion in the market and financial compliance developed with a tight team of accounts. In 2022, it was under scanner of The Income Tax Department for non submission of returns on overseas income TDS delayed payments.

Problem Statements

Non-disclosure of Foreign Receipts:

The company had not disclosed an amount of about ₹ 2.5 crores from overseas clients over two financial years by claiming it was a misinterpretation of export income provisions under the Income Tax Act.

Delayed TDS Compliance:

Syntrex withheld taxes on payments to vendors and consultants, but frequently made late deposits, incurring interest and penalties. This also impacted vendor relationships.

Failure to Plan for Tax and to Use Deductions:

The company also hadn't employed available tax-saving measures including the software assets' depreciation, R& D deduction and Section 80JJAA benefits for new hiring.

Solutions

Rectification and Revised Filings:

Syntrex, upon advice of Tax Counsel, voluntarily reported the foreign receipts and filed amended returns for each year. - They clarified the entire mistake and paid the pending taxes (including interest u/s 234A/B/C) which eliminated any disproportionate action.

Strengthening TDS Systems:

ERP Integration for Deduction of TDS and deposit: The company automated its deduction of TDS and deposit process. There were reminders for when things were due. A quarterly reconciliation activity was introduced to monitor correct 26AS credit reporting and vendor adherence.

Adopting Strategic Tax Planning:

Upon the arrival of a new CFO, Syntrex decided to undertake a full tax health check:

o Depreciated internally developed software tools.

o Claimed benefits of Section 10AA under SEZ for their new office.

o Claim on Section 80JJAA for recruitment of 100 and above employees during the last year.

o Invested the profits again in new plant & machinery to which deductions under Section 35AD were available.

Not only did these steps minimise their tax outgo, they were also fully protected against the direct tax rules.

Reflective Questions

What were the significant compliance vulnerabilities with regards to Syntrex's operations and how might these have been mitigated sooner?

How can small and medium enterprises (SMEs) keep up-to-date with direct tax laws with scant resources?

What are the consequences of not reporting international income under indian tax laws?

Why It's a Must-Have: You're doing tax planning even as a growing start-up?

Examine how digital solutions and technology have supported VAT compliance by medium-sized businesses.

Conclusion

Facts of the Case Syntrex Solutions is a strong example of how growing businesses in India struggle to navigate their way around our direct tax laws. Although non-compliance is generally the result of ignorance rather than malice, it can lead to everything from financial fines and a tarnished reputation, to legal problems. Tax as a growth enabler: Leveraging strategic tax planning, prompt compliance, expert advice and tech automation to take tax from risk to reward The case serves as a reminder that in an economy that is digital and global, tax literacy is no longer a nice-to-have — it's a must-have.

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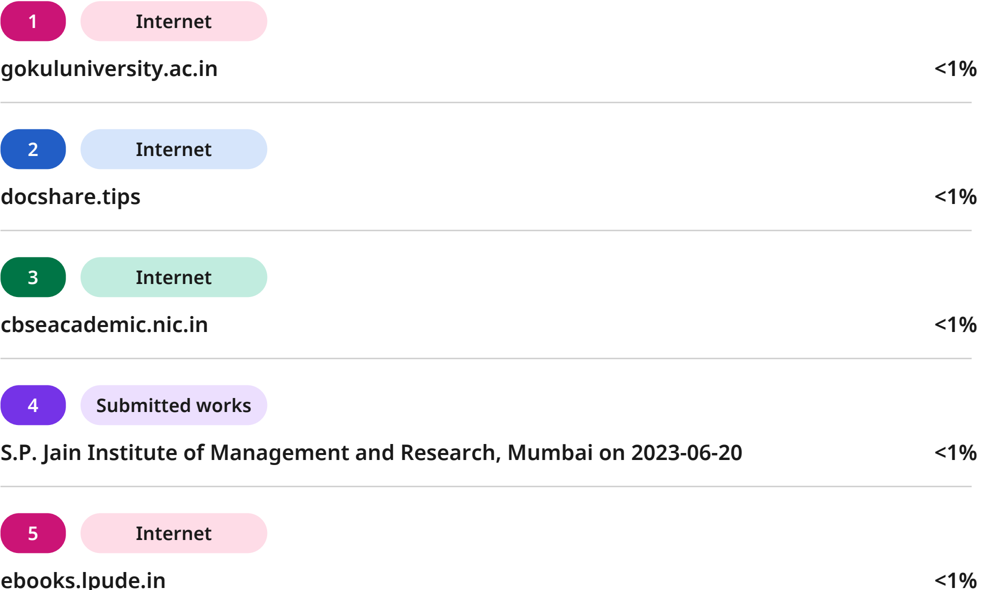

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Unit 2 Key Definitions under Income Tax Act, 1961

Learning Objectives

1. Understand the significance of statutory definitions under the Income Tax Act, 1961, and their role in determining tax liability.

2. Identify and explain the legal meaning of key terms such as "Assessee," "Assessment Year," "Previous Year," and "Income" as defined under the Act.

3. Distinguish between various categories of assesses including individuals, HUFs, firms, companies, and local authorities.

4. Interpret the scope and applicability of the term "Income" under Section 2(24) of the Act.

5. Analyze the relevance of the definitions in assessing income under different heads such as salary, house property, business, capital gains, and other sources.

6. Apply the definitions to solve basic computation problems related to tax liability and eligibility.

Content

2.0 Introductory Caselet

2.1 Definitions under the Act

2.2 Previous Year and Assessment Year

2.3 Basis of Charge and Scope of Total Income

2.4 Capital and Revenue Receipts

2.5 Summary

2.6 Key Terms

2.7 Descriptive Questions

2.8 References

2.9 Case Study

2.1 Definitions under the Act

2.1.1 Definition of 'Person' [Section 2(31)]

In Income Tax Act, 1961 (henceforth "ITA 1961") the concept of person assumes paramount relevance in as much as it delineates who all are liable to be taxed under ITA 1961 within India. The expression 'person' is defined by Section 2(31) and it is an inclusive definition. As a comprehensive definition, it goes beyond the common notions of human being as a factually occurring flesh-and-blood individual and includes certain legal as well artification entities. This is the widest meaning which brings within its net every kind of entity earning income and capable of undertaking liabilities under law to be taxed under the Act.

Who is an Assessee: The term "person" is key to the determination of who can be categorised as an assessee and it impacts on calculation of Income tax, income tax payable, income tax returns filing conditions etc. Every class of person under the Act is a separate unit for assessment and has its own particular provisions in respect of computation of income and liability therefor.

Under Section 2(31), person includes the following:

• Person: This is the description of a human being, male or female. 1.3 The taxpayer under the Act – an individual An 'individual' is the most general and frequently occurring form of a taxpayer which is governed by the Act. People are taxed at slab rates, progressively tax rates where the rate of tax increases with income. For example, a monthly paid salaried employee is calculated an individual.

• Hindu Undivided Family (HUF): It is a family body that is in compliance with the Hindu law and consists of members from various generations, or lineally descended from a common male ancestor, along with their wives and daughters who are unmarried. An HUF is regarded as a separate legal entity, distinct from its members for the purpose of income tax. It's capable of owning property and being in receipt of the income, and it has a separate assessment under the Act. HUFs can claim deductions (e.g. under Section 80C) in addition to the deductions which individual members of the family have separately claimed.

• Company: A company means an Indian company incorporated under the Companies Act and a foreign company incorporated OUTSIDE India but having income received or derived from India. Artificial man Ifa company of the class I am considering were endowed with power such as belongs to a natural person, for example, if it could sue and be sued; hold property but not have a body to be kicked and a soul to be damned, there would be no difficulty in saying that it was beneficial to the community. Company taxation is regulated on a number of articles, taxed under set corporate tax rates. Rate may change, based on turnover, nature of business and eligibility for concessional schemes or exemption.

• Firm: That is registered and unregistered partnership firms under the Indian Partnership Act, 1932 and LLPs registered under the LLP Act, 2008. A firm is treated

as a separate taxpayer independent of its partners. The Firm pays tax on the whole income and the share of profit from firm received by partners is exempt in their hands to avoid double taxation.

• Association of Persons (AOP) or Body of Individuals (BOI): These are a cluster of individuals who enter into collective action to achieve something, generally an earning. AOP may be comprised of any persons, firm, company or any other entity and a BOI consists solely of individuals. The income of an AOP/BOI is chargeable to tax at the maximum marginal rate or the applicable slab rates as the case may be on satisfaction of certain conditions set under the Act. They're not required to be formally registered, but they have to work together to make money.

• Municipality: This refers to the local bodies constituted by a state or centre which are responsible for local governance and administration. Local authorities are persons separate from individuals and liable to tax on non-exempt income under the Act. Income received by local authorities, in particular those connected with public utility services, may be exempt from tax.

• It is an artificial juridical person., [10] These comprise of universities, trusts, statutory corporations and even religious deities in some cases. They have independent legal right, own property and liabilities, and they are distinct tax payers according to the Act.

Explanation to Section 2(31) is not exhaustive in nature and it is inclusive, so as to include any other person of whatever category be, who has been entitled / liable to pay tax though such persons are not spelt out in the said section directly. This overarching strategy enables the Income Tax Department to extend its taxation net across various sources of income.

In conclusion, identification of the various "persons" under the Act is crucial in discerning how taxation will be levied, the tax rates that should be applied and most importantly, obligations as provided for by statute as they apply to the different types of taxpayers. The classification in turn controls income measurement, potential exemptions and compliance enforcement under the Income Tax Act.

2.1.2 Definition of 'Assessee' [Section 2(7)]

Assessee is one of the basic concepts in income tax law which refers to a person who is liable to be taxed and s/he also refers as he should be liable regarding assessment, taxation and compliance. If we refer to Section 2(7) of the Act, an assessee means a person who is liable to pay any tax or any other sum of money in terms of the Act.

3

due under the Income Tax Act. But the term is not limited to persons, who are presently responsible for paying tax; people undergoing assessments, litigations, recovery of dues or other compliances would also be covered therein though they may not have been the original taxpayers.

This definition is deliberately wide to capture all those legally responsible under the Act, whether directly or indirectly. It also has the additional family members who have legal implication due to lack of following procedural requisites, pending litigation filed by IT Department.

Categories of Assessee:

The Income Tax Act has provided three main classifications of assessees and each of such classifications represent a separate principle both from legal as well as from practical point of view.

- Ordinary Assessee:

An assessee is any person who becomes liable to pay tax, which in this section refers to an individual whose income exceeds a specified amount. This comprises persons who are mandatory to file income tax police and also pay taxes following their income criteria. Illustration: If an assessee is an employee who earns salary in a financial year and file income tax return with respect to such income thben he's a normal assessee.

- Deemed Assessee:

1What is a deemed assessee?A person who has derived income in some form or the other but may not be the original earner of such income, yet such person is treated as an assessee under the law because of existence of certain conditions. This usually occurs in an inheritance, custody and representationcase. For example, if a man dies after earning income that is taxable but before filing his income tax return, it is duty of his legal heir to file the return and pay taxes due. In such a case, the legal heir is considered as deemed assessee.

- Assessee in Default:

An assessee in default is one who does not comply with an obligation, duty or law and this includes a person who fails to fulfil the requirements of the Income Tax Act. This could be for non-deduction of TDS, delay in depositing TDS or non-payment of advance tax, among other things. Although such party may not be the true taxpayer, their action in failing to comply with sections of the Act also makes them personally liable for penalties and interest and prosecuted in certain cases.

Illustration: An employer who does not deduct tax at source on the salary paid to an employee is deemed to be an assessee in default.

Assessee also defined to include;

- Persons under Investigation or Scrutiny:

Any individual whose income is under investigation for tax evasion, even if no liability has been ascertained, is an assessee. These people or bodies are overseen by the Act for investigation and evaluation.

• Persons Served with Notices:

Individuals who receive statutory notices under the respective provisions, including Section 142 (inquiry before assessment), Section 143(2) (notice for scrutiny assessment), or Section 148 (notice for reassessment) are considered as 'assessees' notwithstanding the final liability has not been determined.

• Individuals that are parties to Appeals or Litigation:

Persons or business entities involved in any appeals to the tax and revision or judicial review process relating those as well, are included herein also as they are part of the legal system for determination and responsibilities of taxes.

Importance of the Term "Assessee":

The definition of an assesse as seen is important for application and enforcement of the Income Tax Act. The word performs several useful roles:

• Starting Point of Assessment:

The process of assessment i.e., determining income, computing tax liability and ensuring compliance starts with the identification of the Assessee.

• Determination of Legal Responsibility:

The term serves to determine exactly who is legally liable for paying taxes, filing returns, and dealing with notices and penalties or even prosecutions in case of noncompliance.

• Widening the Tax Net:

Cross-References 234 Interpretation 3(42) — the definition of “assessee” is inclusive and it will cover under deemed assessee and assessees in default to ensure that a tax net must be very wide enough to include all persons who can be legally held liable for payment of taxes being successors, representatives, etc.

• Enabling Legal Action:

No one can be proceeded against for the recovery, imposition of penalty or prosecution, unless he falls within the category of assessee under the Act. This provides legal bite and teeth to the definition.

Illustrative Example:

Let us consider Mr. A – a businessman, who passes away without filing his income tax return for the financial year in which he earned his taxable income. The business and the assets pass to his son. In this situation the son shall become a `deemed assessee' and would be bound to submit returns on behalf of his late father and discharge tax liabilities. He might also receive notices or inquiries in case the declared income falls under assessment.

2.1.3 Definition of 'Income' [Section 2(24)]

The pivotal idea/ underpinning doctrine of "income" is the backbone to the Income Tax Act, 1961; as it seeks to tax income. Notions of income And it facilitates the administration and enforcement of a coherent system of taxation. Definition of “income” in Section 2(24) The term “income” has been defined under section 2 (24) of the Act inclusively and widely. An extensive definition means that income includes not only what we categorize in everyday life as income (such as salaries or profits from business) but also the general provision of statute law which embraces various specifically authorized receipts, which may not be naturally considered as income but are nevertheless made so by specific legal rule.

The definition is intentionally cast wide with a view to covering any source of revenue which can be thought of, immediately or in future; and it may cover not only sources of recurring returns but also transactions in the nature of capital gains whether speculative or otherwise. This provides for flexibility and freedom of application in the administration 0of tax law and at the same time, avoids evasion or avoidance of tax through loopholes.

Key Inclusions under Section 2(24):

The following are significant classes expressly described within the meaning of income:

• Profits and Gains of Business or Profession:

This is the profit an individual earns by engaging in any business or profession. It comprises all kinds of profits—regular, speculative or even notional profit as per certain provisions.

• Dividends:

Dividend income includes the earnings generated from owning shares in a company. This also applies to deemed dividends under Section 2(22) which includes certain payments made by closely held companies to its shareholders and treated as dividends even though not declared out of profit.

• Voluntary Contributions:

Income includes amounts voluntarily contributed to the trust, religious establishment or charitable organization. Such contributions are taxable with an exemption under provisions such as Section 11.

• Perquisites:

All benefits, amenities or facilities given or provided by an employer to employee are taken into account in the total income of the employee as a perquisite,except those specifically exempted.For instance:,free housing, car for personal use without applying any usage cap amounting to Rs-15,000 (Including maintenance and insurance) concessional loans etc. of which the value is not included in payment while calculating tax ability provided they are allowed to directly be used by his employees; and their cost has been borne by the employer.

• Capital Gains:

Income includes income derived from the sale of capital assets, such as real estate, shares and bonds. The capital gains can either be short-term or long-term, and depends on the duration for which you have held the LTCG.

• Winnings from Games and Lotteries:

Even proceeds of lotteries, crossword puzzles, horse races etc are covered. They tend to be taxed at a standard rate, without any exemptions.

• Interest, Salary, and Bonus:

Such income includes salary, compensations, benefits or privileges such as bonuses and interest from fixed deposits or other investment instruments.

• Rental Income from Property:

whenever an individual lets out, the income derived from letting has to be treated as house Property Income. Even if you inherit or are given the property, rent is still taxable.

• Gifts Received Without Consideration:

In case of gifts received by an individual or a HUF (Hindu Undivided Family), to the extent aggregate fair market value of such gift /s during the previous year exceeds Rs.50,000/, the same shall be liable to tax under section 56(2). There are exceptions, however, for gifts from relatives and other special occasions such as marriage.

Characteristics of the Concept of Income:

The distinct elements of the concept of income render it especially useful and enforceable:

• Inclusive and Expansive in Nature:

The definition is not exhaustive and may cover new or non-traditional sources of income at the discretion of the tax administration.

• Deals with Income Both Received and Accrued:

The income can be taxed on receipt basis (when it is actually received) or an accrual basis (when the right to receive arises), according to the method of accounting followed by the assessee.

• Does Not distinguish between Legal and Illegal Earnings:

"It looks at all forms of income - both legitimate and illicit. Income from illegal sources is also taxable.

• Covers Both Cash and Kind:

It is not necessary that income be in the form of cash, it could easily be 'in kind'. As an example, being gifted a car by an employer may be tax

• One-Time or Recurring:

Both earned (e.g., wages) and unearned income (e.g., interest, dividends) - whether received periodically or as a lump sum - can be deemed income if the payments are both periodic AND regular in amount.

Example Illustrating Subject Matter For and the Scope of Income:

• Any monthly payment by way of salary paid in advance is regular income under the head "Income from Salaries".

• A single-time winning from lottery of ₹1,00,000 is income chargeable to tax under the head "Income from Other Sources".

• Taxability of a gift received from a non-relative: – If Y receives ₹1,50,000 as gift from X [i.e. non- relative], the same shall be taxable in his hands as it exceeds ₹50,000 which is chargeable @30% of income plus surcharge and cess under section 56(2)(x).

Classification of Income for Computation:

For the purpose of computation of total income, under the Income Tax Act, income is classified under five heads and each head is ruled by its distinct rules:

Salary Income – Covers the salary and wages earned from work including bonus, commission and perks.

House property Income – Includes let out or deemed let out income of owned house properties.

Profits and Gains of Business or Profession – The income that arises from trade, profession or vocation comes under this head.

Capital Gains – Dealing with the gain made on transfer or sale of capital assets like land, buildings, stocks and so forth.

Income from Other Sources – A balance head covering all taxable incomes which aren't included under other heads e.g. winnings from lotteries, gifts and interest income.

Significance of Defining Income:

It is crucial to know the full spectrum and definition of income for:

• Calculating total income and the tax.

• Your eligible exemptions and deductions.

• Fulfilling all tax reporting obligations in the United States.

• Evading penalties and legal implications of underreporting income.

• Figuring out which income is classified under what head, as it impacts deductions and tax rate.

Even if a receipt doesn't form the normal menu of income can be charged, provided it is included in the Deemed provisions under Section 2(24) inclusive. For that reason, it is important for taxpayers and practitioners to have a good grasp of this provision so the law can be applied correctly.

2.1.4 Concept of Gross Total Income and Total Income

Gross Total Income (GTI) and Total Income are basic concepts for working out tax liability according to the provisions of the Income Tax Act. These concepts are related but not identical in semantics and computation.

Gross Total Income (GTI):

GTI is the sum total of incomes computed under the five heads of income, without any deduction u/s 80C to 80U. It includes:

• Salary

• House Property

• Business or Profession

• Capital Gains

• Other Sources Formula:

GTI = Total income of all the five heads (after adjusting intra-head and inter-head losses)

GTI is the derived income to decide the eligibility for several deductions and exemptions. Total Income:

Total income is computed after claiming all eligible deductions from GTI under chapter VI-A. This is the ultimate taxable income tax applies to.

Formula:

Income Total (A) = Gross total income – Deductions under Sections 80 C to 80 U

Key Points:

• Total Income (rounded of to the nearest ₹10).

• Rebate underSection 87Aand surcharge (if applicable) is allowed on Total Income.

• Tax Slabs are based on the Total Income.

Illustration:

Let us further assume that GTI of Mr. X is ₹8,50,000. He takes deductions pf ₹1,50,000 under Section 80C and ₹25,000 under 80D.

Then:

• GTI = ₹8,50,000

• Deductions = ₹1,75,000

• Total Income = ₹6,75,000 It is important to know this for the following:

• Filing income tax returns accurately.

• Planning tax-saving investments.

• Avoiding under-reporting of income.

Misclassification, missing cost deductions can result in over tax or penalties.

2.1.5 Exempt vs Taxable Income

It is essential for accurate assessment of tax liability that under the Income Tax Act, 1961 there has to be a clear demarcation between exempt income and taxable income. General Information How much of what we earn is actually taxable? Some income is fully subject to tax, others only part.

on some sections of the Act, whereas certain are deemed included in total income and taxed thereat. Grasping this difference is important because not only may it ensure accurate filing of returns, but also compliance and avoidance of penalties.

Exempt Income

Exempt incomes are those incomes which do not attract tax liability, either in full or in part, under the provisions of the Income Tax Act. Even the exempt income is not added in the total gross income, it has to be reported in the ITR in Schedule "Exempt Income". The relief might be stated as unconditional or require qualifying terms such as limits, restrictions on use, or eligibility requirements.

Examples of Exempt Income:

• Agricultural Income [Section 10(1)]

Agriculture income originating from land in India is completely tax-free. But it is considered for rate purposes (tax rate slab benefit) in some cases when the non-agricultural income exceeds the basic exemption limit.

• Share of Profit from Partnership Firm [Section 10(2A)]

As the firm itself (assessed as a separate entity) is taxed, any share of profit income received by the partner from a firm assessed on separately basis is exempt in his hands.

- Withdrawals from Provident Fund

Except under specified circumstances (including 5 years of continued service), withdrawal from recognized provident funds is tax-free.

- LTCG of ₹1 Lac – Section 112A

LTCG on sale of listed equity share or equity-oriented mutual fund up to ₹1,00,000 per financial year is exempt. This is from 86-08; after this the tax rate becomes a more advantageous (but still flat) 10% with no indexation.

- Other Allowances of Government Employees, Diplomats

Foreign allowance. UN salary And Perquisites to Diplomats etc are exempt as per sub clauses of Section 10.

Key Characteristics of Exempt Income:

- Conditions or Limits May Apply

The exemption extends only under conditions which it specifies. For example, LTCG exemption u/s 112A has conditions of holding period and payment of STT (Securities Transaction Tax).

- Must be Reported in the ITR

Executable income should be disclosed in the return eventhough not taxable to have transparency and peace of mind without receiving notices from Income Tax Department.

- Misreporting Can Lead to Scrutiny

If there was a wrong reporting or failure to report the exempted income, an assessment could be made as being chargeable to tax audit penalties would also fall under the purview of ACA.

Taxable Income

Taxable income (as defined) is that part of a person's earnings subject to tax under the Act. It comprises all incomes excluding those that fall under the five heads of income, unless such income is specifically exempted. This income is included in the gross total income and becomes liable to be taxed at the rates as applicable, after considering allowed deductions as well as exemption if any.

Examples of Taxable Income:

- Salary Income

Comprises salary, dearness allowance, incentives, bonuses, commissions and perquisites from employer.

• Rental Income from House Property

Income from letting out property by way of rent is an earning, which falls under the head "Income from House Property."

• Profits and Gains of Business or Profession

Profit made in carrying on a trade, business or profession is assessable provided expenditure has been incurred for earning that profit.

• Interest Income

What are the tax implications on interest income from fixed deposits, RDs, bonds and savings accounts? Subhash LakhotiaIf the interest earned is from bank FDRD/bonds/saving bank account then it will be taxed under the head "Income from Other Sources''.

• Winnings from Lottery or Gambling

Full amount of income on lotteries, card games etc., will be taxed at a flat rate of 30% as "Income from Other Sources" and no deductions are allowed.

• Short-Term Capital Gains (STCG)

STCG on the listed equity shares, on which STT is paid, is taxed at 15% under Section 111A.STCG on other capital assets are taxed at normal rates.

Taxable Income is Subject to:

• Slab Rates for income tax for Individual and HUF parties 1.

Tax is payable by individual taxpayers and Hindu Undivided Families based on the slabs or categories classified by government, higher income group, attracts higher rates.

• Companies and Partnerships Flat Rates

Domestic companies and partnership firms are taxed at predetermined rates, say 22% or 30%, depending upon their turnover and chosen tax regime.

• Special Rates for Specific Incomes

Some income, such as short-term capital gains (those held for less than a year), are taxed at higher rates and should be treated in separate sections as described.

Significance of the Distinction

It is important that income should be properly classified as exempt or taxable for correct tax calculation. Errors in classification can be costly:

• Reporting Taxable Income as Exempt

That could mean owing penalties, interest or potentially criminal charges for underpayment of the tax.

under section 270A or 276C of the Act.

• Reporting Exempt Income as Taxable

This may result in taxpayer's paying tax twice, which would decrease their net income and potentially require the filing of a refund claim.

• Scrutiny and Notices

Unmatched income disclosure and real financials can lead to notices of scrutiny or re-assessment by the Tax Department.

"Activity: Tax Terminology in Practice: Identify and Classify"

In this activity, students will be given a list of 20 income-related items, including salary, pension, agricultural income, gifts, and capital gains. Working in small groups, they must identify each item as either exempt or taxable, cite the relevant section (if applicable), and classify it under the correct head of income. This exercise promotes the practical application of definitions, strengthens section referencing skills, and prepares students for real-world tax filing and advisory scenarios.

2.2 Previous Year and Assessment Year

2.2.1 Meaning of 'Previous Year' [Section 3]

The "Previous Year" forms the fundamental basis in the realm of taxation as provided by the Income Tax Act, 1961. Under Section 3 of the Act, "previous year" would mean the last previous year which referred to the financial year immediately preceding the assessment year in question. That is the year in which you have received the income and based on that, tax liability on such income is calculated and assessed in next year (that is called assessment year). The uniform financial year of all General taxpayers in India is 1st April to 31st March the next calendar; and for Corporate it is the same time period as provided under Companies Act, 2013.

Statutory Definition (Section 3):

According to Section 3:

" 'Previous year', in relation to any assessment year, means the previous year for that assessment year.".

If the AY is 2024–25, then the PY would be 2023–24; which means from 1st April 2023 to 31st March 2024. If an individual or entity makes any income during this period they will be taxed in AY 2024-25.

Key Features of the Year Gone By:

• Uniform Duration:

The preceding year is always the previous 12 months ending on 31st March beginning from 1st April irrespective of the accounting year or business activity of an assessee.

• If you are newly set up business or profession:

If a taxpayer starts new business or profession in the middle of financial year, the income earned from date of starting to 31st March is considered as previous year and such period should be treated as an accounting year even it is for less than 12 months.

Example:If a business is commenced to be carried out on the 1st day of October, 2023, period for such business from 1st October 2023 to 31st March, 2024 will be previous year.

• Lump sum Previous Year to be same as PVI for ALL Sources of Income:

Whereas, in cases where there is a different source of income for the taxpayer [like salary, house property, business income and capital gains], then all incomes from different sources are calculated for that previous year, i.e., 1 st April to 31 st March.

Significance of the Concept of Previous Year:

So, knowing what is previous year is very much required as it holds the deciding word for almost all the procedural as well as substantive provisions of Income Tax Act. India's income tax is assessed on a preceding year basis (i.e., the income earned in a particular year is taxed only in the following one). This has several implications:

• Income Computation:

The aggregate income of an assessee is computed on the basis of income derived in a previous year. All sources of income, all deductions, all exemptions are looked at in the light of this year.

• Determination of Tax Liability:

Tax slabs, rates and surcharge applicable in the assessment year are levied on income of previous year.

• Compliance Requirements:

Liabilities like filing income tax returns, paying advance tax, deduction of TDS(Tax Deducted at Source) and audit are connected to one's previous year(s)'s income.

• Assessment and Reassessment:

Where any such assessment proceedings, enquiry, revision have been issued as against income events taking place in the immediate earlier year.

Illustrative Example:

Let’s say Mr. A, a Salaried employee earns income between April 2022 to March 2023. This vintage is the 2022–23 previous year. The income received in this year will be taxed and the liability would be calculated in Assessment Year 2023–24. Mr. A has to submit his Income Tax Return in the Assessment Year, but with regard to the income that will be considered for calculation, it is assessed on the previous year.

2.2.2 Concept of 'Assessment Year'

Assessment Year (AY) is a significant construct in the architecture of the Income Tax Act, 1961, albeit is not described as such in Section 2 of the said Act. Although not defined in so many words, the meaning is well-known by usage and context in different sections of the act. Assessment year is the period of 12 months starting from April 1, ending on March 31 of the next calendar year, in which the income earned during the previous financial year (commonly known as previous year) is assessed for tax by one of Income Tax department.

The income of the previous year is for the purpose of taxation, collected in a particular form in the subsequent year, which period is called (1) asessment year i.e.,in the following financial year and/or(2) Period A.Y means immediately after through out nine months of Next Financial Year In any part or whole time etc.

Illustrative Example:

If an assesse receives income in the Financial Year 1 April 2022 –31 March 2023, it is called Previous Year (PY) 22–23. This income will be examined, taxed and ensured by the Tax Authorities during the Assessment Year 2023–24 (FY 1st April 2023 to 31st March 2024).

Salient Features of the Year of Assessment:

• Uniform Time Frame:

The assessment year is always the financial year immediately following the tax year for that assessment; it tends to run from 1 April to 31 March and matches a full calendar year.

• In this year, assessment activities take place:

All important income tax mechanisms take place in the assessment year: they include filing return of income, claiming refund, issuance of notice under Section 142(1), 143(2) or 148; scrutiny assessments, levy of penalty and filing appeal among others.

• Applicable Tax Rules and Rates:

The rates of tax, limits for deduction, provisions for exemption and surcharge/cess to be taken into account for calculating the tax are those notified for the assessment year although they are calculated with reference to income of the previous year. Hence, all changes made in the Union Budget are applicable from first assessment year.

Relevance and Significance of the Assessment Year:

Assessment year is the backbone of income tax system, as it forms the basic period on which all other compliance & enforcement base. Its functions include the following:

• Legal Framework for Tax Assessment:

The 'assessment year' is the period during which the Income Tax Department evaluates your income tax return filed for the previous year, verifies it, and processes it. It brings uniformity in the date of enforcement and applicability of tax laws throughout India.

• Determines When Tax is Payable:

Even though one earns the income in a year, he gets to know how much tax is to be paid or refund is to be received on his income only in the next financial year called as assessment year. There may be some advance payments like TDS or advance tax which is paid in the previous year, however computation and settlement of final liability with the government is done in a assessment year.

• Triggers Compliance and Enforcement Mechanisms:

The year for assessment serves two other time-frames, the period where breaches are discovered and notices, penalties or prosecutions are issued under relevant sections. For example, not filing return of income by due date in the assessment year may lead to interest under section 234A or penalty under section 271F.

• Legal Information and refunds details:

Refunds are granted-in any -excess of tax is paid claims in assessment year. So do the appeals, revisions and rectification procedures - all in respect of the assessment year relevant to the income concerned.

Practical Illustration:

Let's assume Mr. B, who is salaried person generates an income of ₹10,00,000 for the financial year between 1st April 2022 - to 31st Mar 2023. This period is the Prior Year 2022–23. Mr. B has to file his income tax return in the Assessment Year 2023–24 (starting from 1st

April 2023). Any scrutiny, the refund processing or penalty (if any) would be done in the Assessment Year 2023–24.

Why a Separate Assessment Year?

Following the notice of assessment for AY and the income accrued in PY, there are several operational and administrative uses for the interval between PY and AY:

• Each year's financial transactions can be done before they are taxed.

• It gives the taxpayer enough time to compile income information, calculate their tax liability, and send in their return after the close of the previous year.

• It allows Tax department to implement the new rates, rules, and laws introduced by the Finance Act for concerned assessment year.

2.2.3 Relevance of Previous Year and Assessment Year in Tax Computation

Previous Year and Assessment Year in Indian Income Tax Act: In the Indian income tax act, "PY" and "AY" are structurally bound by each other and they are integral for calculation, assessment and collection of tax. This is not a mere academic or formal difference, but runs right through the fabric of the whole process prescribed under the Income Tax Act, 1961ResponseBody. It is important for the taxpayers, tax practitioners and the revenue department to know how these two periods operate and interplay so that there could be uniformity, certainty and predictability in tax regime.

In this context, the Previous Year is the financial year in which income is earned, and the Assessment Year is the one which follows it, in which such income will be assessed and taxed. For instance, income of the PY 2022–23 is assessed for and taxed in AY 2023–24. This gap of one year gives to both the assessee and the tax department time to cover at least a full financial year before taxes are levied.

Areas Where AY and PY Are Significant:

Basis of Income Chargeability

• Assessee has to pay tax on his income in the subsequent year if any exce ption is not made.

• Section 4 of Income Tax Act provides the basis by declaring that income earned in a preceding year

is chargeable to tax in the previous year or in any earlier previous year.

Explanation: This means that all transactions of a fiscal year are locked until its final scrutinization/taxation. Exceptions to this general rule (such as where the business is a non-resident shipping business or has ceased trading) are covered by separate provisions requiring tax to be paid in another year of income.

Return Filing

• When one fills in their Income Tax Return (ITR), it is for the assessment year, but the income is of the previous year.

• You will have an assigned form number, due date and disclosure requirements depending on the year of valuation.

Explanation:For instance, for AY 2024-25, any return would be with respect to income earned during the PY 2023-24. All these statutory timelines, penalties for late filing and choice of ITR forms are based on the assessment year.

Relevant Tax Rates and Regulations

• The tax rates, exemptions, deductions and reliefs applicable to the income of earlier year are provided by the Finance Act enacted for that assessment year.

Explanation: Since the income pertains to an earlier year, the corresponding provisions will be those of the assessment year. For instance, proposed any changes in slab rates, surcharge and deductions will be applicable from Budget 2023 affecting AY 2023–24 on the income earned in PY 2022–23.

Compliance Tracking and Enforcement

• Form thus covers all notices (being in the course of scrutiny or reassessment) refunds, penalties and rectifications with reference to assessment year.

Explanation: Notices under section 143(2) or under section 148, all mention the Assessment Year that is being considered. The same holds good in the case of penalty proceedings and interest computation under Sections 234 A/B/C but these relate to time frame of assessment years.

Set-off and Carry-forward of Losses

• You can carry forward or carry back any losses suffered in the previous year against assessment years.

under the provisions of Sections 70 through 80.

• Depreciation, business losses/capital losses which are to be unabsorbed for the purpose of computation must be kept in mind and properly followed up across assessment Years to make proper claims.

Explanation :"For example a capital loss in PY 2022–23 can be carried forward up to eight assessment years subsequent to Assessment Year 2023-24". Correct classification is required in order to correctly set-off against future profits.

Audit and TDS Reconciliation

• Tax Deducted at Source (TDS) being deducted and deposited in the previous year at the time of payment or credit.

• Verification and reconciliation of TDS takes place in the assessment year too by way of Form 26AS and TDS schedules in ITR.

Explanation: Section 44AB tax audit for a business refers to the financial figures of last year but the audit is done and reported in assessment year. " Form TDS Certificate (Form 16/16A) are given in respect of PY transactions however utilized for return filing in AY.

Significance of Clear Understanding

The distinction between former year and assessment year is definitely a rational pattern of taxation. It ensures that:

• Full financial information is provided before any tax is calculated.

• All the statutory compliances of return filing, audit, TDS compliances and self-assessment tax also sync along with these timelines''.

• Clarity and efficiency of law is retained, minimizing uncertainty for taxpayers, and tax authorities.

But Does Not Properly Identify/Report Income In CYs Other Than The Correct PY/AY However a failure to properly identify or report the income in a CY other than the appropriate PY/AY may result in:

• Incorrect tax calculation

• Rejection of deductions or carry forward filings

• Penalties and interest

• Delays in refund processing

• Scrutiny or reassessment proceedings

2.2.4 Exceptions: Income Taxed in the Same Year

It is the general rule that the income of Previous Year will be charged to tax in Assessment Year, however there are certain exceptions where income is charged to tax in the year in which it is received. The purpose is primarily to avoid loss of revenue in certain situations where prospective taxation might not be practicable.

Major Exceptions:

Non-resident Shipping Business (Section 172):

o A foreigner engaged in shipping business can earn income in India and become indifferent.

o In those instances, the revenue is recognized and taxed in the same year rather than spreading it over three years so that the entity can pay it before it exits.

Persons Leaving India (Section 174):

o Where it is likely that an individual would leave India permanently/ for a considerable period of time, without making necessary arrangements for discharging tax liability, income upto the date of departure of such individual will be charged to tax in the same assessment year.

Discontinued Business (Section 176):

o If a business or profession ceases to be carried on any time during the year, income up to the date of cessation is charged in that year so as not to be lost.

AOP/BOI Dissolution (Section 174A):

o If a body or association of individuals is dissolved, its income in the year of dissolution is taxed.

Recovery Difficulties:

o In any situation where the assessing officer has reason to believe that the recovery of tax will be delayed, assessment may be accelerated and also taxation.

Rationale for Exceptions:

• Such provisions safe-guard revenue interests of government where the regular assessment in the subsequent year is not feasible or convenient.

• They allow summary judgment and early recovery procedures.

We strictly read and apply such exceptions under the law, and there must be proof for them to be raised. In such case, the income is chargeable to tax in the year of receipt itself which also overrides the normal assessment year scenario.

2.2.5 Example Scenarios for Previous Year and Assessment Year

Thinking about PY and AY may be more clear through some real examples; To illustrate that income is in fact, all too real and counted and reported as such – let alone taxed at the rates which it contrarily proposes (not rises) when statutory schedule are mastered.

Example 1: Salaried Employee

• Mr. Kumar works in a private company and earns a salary from April 1, 2022, to March 31, 2023.

• This income is related to FY 2022–23.

• He is assessed to tax in AY 2023–24 based on his return.

Example 2: Business Income

• Buisness of Ms. Neha which generates ₹15,00,000 during the FY taxable shall be Zero.

• She files ITR of AY 2024–25 and pays tax for this income.

• If she established the business on 1 July 2023, her PY would still finish on 31 March 2024 despite the fact that it only lasted for nine months.

Example 3: Discontinued Business

• On Dec. 31, 2023, Mr. Ali closes up shop for the retail business.

• The revenue for the period April 1 to December 31, 2023, will be assessed in the financial year provided that there is no possibility of moving him after December 2023 (Before such date he would cease to operate), since thereafter he cannot get recovery under Section 176.

Example 4: Non-Resident Shipping

• A foreign shipping company stages a voyage out of Mumbai in July 2023 and exits Indian waters in August.

• Levy on the income accruing from the trip is charged in FY 2023–24 itself under Section 172 and not for AY 2024–25.

Sample 5: Audit of Tax & Return Filing

• XYZ Pvt. 2006-207), Ltd. realizes business income in PY 2022–23.

• It is liable to tax audit and it's return of income for AY 2023–24 under Section 139.

• Tax is calculated in accordance with the AY rules but taxed on income of PY.

These examples demonstrate how the definitions of PY and AY find its implementation in both contexts, reaffirming the necessity of appropriate classification for compliance and tax calculation.

2.3 Basis of Charge and Scope of Total Income

2.3.1 Section 4: Basis of Charge

Legal framework and key concept Section 4 of the Income Tax Act, 1961 is the charging section which is a gateway of whole taxation process in Indian tax law. It is the constitutional authorization for the Central Government to collect income tax on its citizens as well as corporate entities. This provision lays the groundwork by explaining what is being taxed, who is liable to tax, when the tax is levied and under what power. If there is no such provision of the Act then even though income can be called taxable under other provisions tax cannot be charged.

Section 4(1) provides that income tax shall be levied for any assessment year at the rates laid down by the Income Tax Act, on the total income of the preceding year of every person. This shows that taxation is annual, income is past year's and the taxpayer has to be within what Section 2(31) explains as "assesse" whole that defined expression means a person..".

Section 4: Elements of Section and Explanation:

Taxability is on "Total Income"

• Income tax is not levied on isolated components of income, but rather based on a cumulative total of all taxable income, or what the Act calls "total income."

• This gross receipts is to be ascertained in accordance with the scheme of the Act, more particularly Section 5 of the Act, which deals with determination of total income.

Explanation: Revenue under 102These are income sources like salaries, house property, business profits, capital gains and others all added together to determine total income on which tax is charged.

Legal Authority to the Government

• Section 4 provides the Central Government with the authority to impose an income tax by enacting a Finance Act annually.

• Tax rates, Surcharge, Rebate and Cess for any assessment year is determined and levied through the yearly Finance Act.

Explanation: Although the power to tax is provided in Section 4, amount of tax and due date of payment is determined through Finance Act which is passed during Union Budget.

Scope of the application – Who and What is taxed

•The provision is applicable to "every person" as defined under Section 2(31) of the Act and would cover individuals, HUFs, companies, firms, AOP/BOI, local authority and artificial jurdical person.

• The taxable income should belong to the class of total income, as explained in.

Section 5.

Explanation: As an example, a resident of India is subject to tax on his worldwide income while a non-resident is only subject to tax on income which arises or accrues in India. This distinction arises from the relationship between Sections 4 and 5.

Rate and Slabs of Tax –As provided under the Finance Act

• While Section 4 permits the imposition of income tax, it does not specify any particular rates of said tax.

• Tax rates, slab limit and fiscal concessions or surcharges are separately listed in the Finance Act passed by Parliament each year.

Explanation: For instance, an individual's income is taxed in the assessment year (AY) 2024-25 on these slabs as announced in the Union Budget of AY 2023.

Such general rule and exceptions – when income is taxed

• The principle laid down under Section 4(1) is as follows: Income of the 'previous year' is taxable in the "assessment year".

• There are certain exemptions though when income is charged to tax in year on which it is earned, notably where the possibility of future recovery of tax does not exist.

Examples of Exceptions:

o Section 172 - Shipping business of non residents.

o Section 174 – Persons departing form India permanently or for lengthy period.

o Section 174A – AOPs/BOIs created for a specific event or occasion.

o Section 175 – Instances of cessation of business.

o Section 176 – Income of person likely to dispose off property.

Explanation These exceptions are only for ensuring that the department should be in a position of realising the tax despite the fact that next year the assessee may not be traceable.

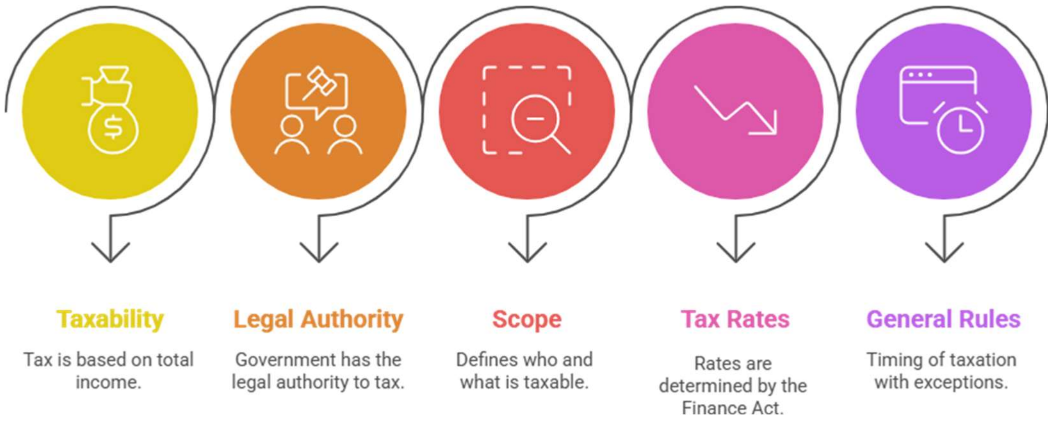

Figure 2.1

Significance of Section 4 in the Taxation Regime

It is not just a preamble but the constitutional sine qua non of income tax in India Section 4. That, with such an indictment Section 4 not being in force:

• The machinery with taxing jurisdiction would not have a tax to impose.

• Other sections of the Act (like computation, exemption, deduction, penalty etc.) would be passed over procedurally.

• You'd end up fighting this one out in court over whether or not income tax could be legally enforced.

And it has also been uniformly held by the courts that there is no tax without a charge. Therefore, though a specific mode of income may seem to come within a computational provision that vis-Ã -vis it is taxable, yet no tax can be imposed unless on reading the charging section chargeability is attracted.

2.3.2 Section 5 – Scope of Total Income

Section 5 of the Income Tax Act, 1961 prescribes the guidelines to ascertain what is "total income" taxable in India. This is the governing provision in determining what income are to be included in the taxable base of an individual by and large on the residential status that ascertained under Section 6 of the Act. 5 the taxation is to be connected with taxpayer's economic nexus with India progressing further equity and ability to pay concepts.

The aforesaid section brings forth sensible arrangement to identify the income arises in India and income restless in foreign and thereby,to test whether tax is liable on such income in India or not based upon his residential status of assessee as whether he is ROR /RNOR/NR.

Section 5: What is Total Income

Section 5 specifies the income of an individual for any previous year which includes – (a) Any income which is received or is deemed to be received in India during such year.

• Income Received Or Deemed To Be Received In India For The Previous Year

This covers all incomes that get actually or constructively received in India (like advance salary, pension, and tax refund).

Explanation: For instance if some money is credited in an Indian bank account as salary directly, then it is taxable (source of earning may be other country).

• Income Accruing or Arising or Deemed to Accrue or Arise in India during the Previous Year This includes income which might be received outside of India but originates in India. This covers interest, royalties, fees for technical services and capital gains arising in India.

Explanation: A property sale in India, resulting capital gains are taxable in India even if the seller is a non-resident Indian and the proceeds are not re-patriated to their home country abroad.

• Income Accruing or Arising outside India (only for ROR)

If he is resident and ordinarily resident, even income which accrues or is earned.

is added in their total income if it is earned outside India.

Explanation : Foreign dividends, foreign salary, rent from property located outside India etc., would be taxed to RORs.

Taxability According to Residential Status

Section 5 functions with Section 6 where residents are divided into three groups. The resulting taxability of the income follows:

Resident and Ordinarily Resident (ROR)

• Taxable on global income

Explanation: (a) All incomes earned or received in India or abroad shall be included in the total income. This will involve foreign salary, dividends, capital gains etc. on your overseas assets, so on and so forth.

Resident However Not Generally Resident (RNOR)

• Taxable only on:

o Income, which is received or deemed to be received in India or accrues or arises in India

o Income arising outside of India if it is from a business controlled in, or profession set up in, India.

Explanation: Interest income earned from foreign bank accounts for an RNOR is not taxable in India. But if they run a foreign firm from India, whose business is controlled from the country, its income could be taxed.

Non-Resident (NR)

• Taxable only on:

o Income received or which are deemed to be received in India

o Income received or deemed to be received in India

Explanation: For a non-resident, income earned outside India, like foreign salary and capital gains on sale of property situated outside India will not be taxed in India until the source of such income is also in India.

Other Significant Components of Total Income

• Income must be classifiable under any of the five heads of income :

o Income from Salaries

o Income from House Property

Profits and Gains of Business or Profession

o Capital Gains

o Income from Other Sources

Explanation : Only the income falling under these heads is to be taken into account for Tax Calculation. All other receipts which do not fall within any of these categories will be non taxable unless proved to the contrary.

• Earnings from India is to be taxed, as always :

Explanation : Irrespective of the residential status of the assessee, if there is an income which accrues or arises in India, it would be taxable. This is to ensure that source-based taxation will always apply.

• Incomes earned outside India are taxable or non-taxable.

Explanation: It would all depend on whether you are a resident of the U.S. or non-resident alien for the period concerned. Such foreign credits do not apply for non-residents and are not subject to tax. At the time of withdrawal for RORs, they are 100% taxable.

Illustrative Examples

• Consultancy income of a non-resident foreigner for service rendered in India for which payment has been received into an Indian bank account is taxable in India.

• A resident individual (ROR) receiving dividends from U.S. shares has to report such foreign income in his/her Indian income tax return.

• The RNOR has rental income from a property located outside India, which is not attributable to any business or profession in India will not be taxable in India.

Place of Section 5 in the Scheme of Taxation

Section 5 is vital section for ascertaining the tax base of each assessee. Moore places the limitation on income, which goes into the calculation of total income, which in turn is a predicate for:

• Computation of income that is liable to tax

• Correct classification according to source of income and place of residence

• Verification of world wide income reporting, particularly for RORs having foreign bank accounts / assets/investments.

• Preventing the levy of Double Taxation by virtue of DTAAs

It would also maintain India’s right to tax income emanating from within its borders, and conform to international norms of taxing global income on the basis of residency.

2.3.3 Income Received, Accrued, and Deemed to be Received

Timing and method of income recognition are pivotal in calculating total income under the Income Tax Act. "There can taxable status vary depending on the method of income recognition, either received, accrued or constructively received (deferred payments)".. Characterization is based on a tax year features: Deferment operation in business devolves from use of accrual accounting. These are the terms for when income is taxable What implications do both have for cash and mercantile accounting systems?

Key Concepts:

• Income Received:

"o Relates to the realization of the income in hands of assessee, is it Cash or Kind or its credit.

o It is any amount that the taxpayer receives and becomes unauthorized to use.

o Example: When the salary is paid on 31st March and it is credited to bank of employee, a withdrawal later doesn't mean that income was not received in current financial year but not cashed.

• Income Accrued or Arising:

o Means income for which the right to receive is vested although payment has not been made.

o It denotes legal enforceability i.e the assessee can realize the payment.

o Example: Interest on an FD which has become due as at 31st March, even if the bank pays it in April, is to be considered as accrued income for the year ending 31st March.

• Income Deemed to be Received:

o Some receipts are regarded as having come in by legal fiction – whether they have been received or not.

o Such receipts are encompassed in total income by legal provisions, i.e. section 7 in particular.

o Examples include:

♣ Employer's contribution to provident fund in excess of eligible limit — taxable as perquisite.

♣ Transfer of balance from an unrecognized provident fund — taxable in the year of transfer.

♣ Salary or pension arrears, even if not received in the current period of income, are included under deeming rules.

Significance:

• Proper classification results in the proper tax year of taxability, avoiding either underreporting or an early reporting.

• Particularly applicable to professionals, businesses and taxpayers who have foreign income or deferred earnings.

• Misclassifying can result in penalties, interest and audit risk.

2.3.4 Scope for Residents, NORs and NRIs

Residential status of a tax payer is the stepping stone for determining what portion of Income is taxable in India. As per Section 6 of the Income Tax Act, a person or any other entity are categorised into three types- Resident and Ordinarily Resident (ROR), Resident but Not Ordinarily Resident (RNOR) and Non-Resident (NR). Total income, as per Section 5 is varying for each category.

Taxability Based on Residential Status:

• Resident and Ordinarily Resident (ROR):

o Taxed on their worldwide income.

All incomes – whether earned on India or overseas, received in India or abroad is taxable.

o For example, salary received in UK and credited to a bank account maintained with UK branch is still being taxed if the status of individual is ROR.

• Resident but Not Ordinarily Resident (RNOR) :

o Taxable only on:

♣ JIncome which arises or is deemed to arise in Indialo.

Income arising outside India, only if it is derived from a business or profession controlled from or set-up in India.

o Example: Passive foreign income, such as interest or dividends from foreign investments, is not taxed unless connected with Indian-controlled business.

• Non-Resident (NR):

o Taxable only on:

omincome which is received or deemed to be received in India, or

♣ Income that accrues or arises, or is considered to accrue or arise, in India.

o Foreign income earned and remitted abroad (with no Indian connection) is not taxable.

o Example NRI working in USA is exempted from paying tax in India if the salary Income is not transferred to Indian account.

Key Implications:

• A residential status can be worked out year by year according to the physical stay and conditions under Section 6.

• There are residents and RNORs whose liability of tax is restricted with a view to avoid double taxation.

• NRIs are normally categorised as 'NR' or 'RNOR', and their foreign income remains mostly out of the purview of Indian tax authorities.

Practical Examples:

• A foreign consultant performing services in India for 60 days and being remunerated by the Indian client is taxable on such income.

• The rent received by an NRI from property in India has to be taxed even if it is sent to a foreign country.

2.3.5 Concept of Deemed Income

Incometax Act 1961 contains the concept of deemed income which is not earned from conventional sense as there are some situations in the Act by using the artificiality of legal fiction for every asset and fringe benefit considering it as income. In these provisions, things that are found to have economic or notional value in the hands of a taxpayer but that do not meet an ordinary income definition are covered. The objective is to curb tax avoidance, maintain horizontal equity in taxation and to tap the indirect gains in the net. Thus, deemed income is not always actual cash and kind and still it is tax as real income subject to certain provisions under the Act.

Deemed income occurs where there is a transfer of an advantage, recovery of an earlier deduction or receipt without quid pro quo. These are the incomes which usually do not form part of any commercial transaction or professional services rendered but still deemed as income in hands of assesse. The Act employs this idea to prevent income-like events from being left untaxed in practice solely because of technical or legal formalities.

Common Examples of Deemed Income:

• Subsection 41.(1): Recovery of Expenses or Losses Formerly Allowed

Any amount recovered in a later year of an amount the deduction for which was sustained over two or more years is as indeed any such recovery actually constitutes income.

Illustration: When bad debts written off and allowed as deduction in previous year are recovered, the same is taxable being deemed business income.

• Section 50C: Income from transfer of Capital Asset below stamp duty valuation

As per the Income-tax Act, where an asset is sold for a consideration that is less than its stamp duty value, such stamp duty value of the asset shall be considered to be the sale consideration.

Explanation: This section contains the rules related to undervaluation of property in sale deed so as to avoid tax on capital gains.

• Section 56(2)(x) : Gifts and no Consideration in kind or not Properties Received without Consideration

Where any person or an HUF receives, in any previous year, from any other person or assessee (hereinafter in this section referred to as the other party), money or property without consideration and the aggregate fair market value of which exceeds fifty thousand rupees, the whole of such aggregate fair market value shall be taken into account for purposes of computing income under the head “Income from other sources”.

Explanation: This encompasses gifts received from non-relatives or property acquired without consideration, or for nominal consideration.

• Section 2(22): Deemed Dividend

Payments by closely-held company for benefit of shareholders—Advances or loans " deemed dividends " if out of accumulated profits.

Reference: Explanation: This prevents the companies from distributing profits through informal channels without paying dividend as well as preventing such tax evasion for Dividend Distribution Tax.

The first type of rule for deemed income is designed to prevent notional, indirect or constructive receipts from evading tax just because they are conceptually difficult to describe as receipts in ordinary language. The provision classifies them as income for the purposes of taxation and taxes them so under the relevant head of income.

2.4 Capital and Revenue Receipts

2.4.1 Meaning and Features of Capital Receipts

Capital receipts means those items which either form a liability or diminish the assets of the assessee. These are generally one time in nature, These are generally not captured through normal course of business operations. Capital receipts are those that affect the financial

position of an entity but they are generally not included while estimating taxable income unless so provided by IT Act.

Features of Capital Receipts:

Non-Recurring Nature:

o Capital receipts are non-recurring in nature and do not occur regularly.

o Example: Sale of an asset or cash inflow.

Affect Balance Sheet, Not P&L:

o These receipts affect balance sheet assets or liabilities, not the profit and loss account.

Not Revenue-Oriented:

o They do not arise in the ordinary course of the business.

o Example : Borrowing funds or raise of share capital.

May or May Not be Taxable:

o Generally, there is no tax on capital receipts.

o But certain other items bring some capital receipts in the tax net, such as capilal gains under

Section 45 be income under Section 56(2).

Examples of Capital Receipts:

• Money received from the sale of land, building and machinery

• Bank or loan from financial institutions

• Partners' capital contribution in a partnership firm

• Insurance reimbursement for loss of a capital asset

• Government grants for capital purposes

Capital receipts are important for the financial planning process, as they signal structural changes in the assets and liabilities of the government. They must be differentiated from revenue receipts to ascertain the treatment for tax purposes, assessment of capital gains, and preparation of financial statements.

2.4.2 Meaning and Features of Revenue Receipts

Revenue receipts are the receipts that flow from the regular business or profession. These items are repetitive und directly associated with the daily course of business of that body, and therefore usually taxable if not exempted by law.

Features of Revenue Receipts:

Recurring and Operational:

o Revenue receipts are received by and large in the course of business or profession, again and again.

o Example: Sales of goods or service fees.

Booked through Profit and Loss Account:

o They are included in the income statement and impact on the net profit or loss.

Taxable Unless Exempt:

o Revenue receipts form part of the gross total income and are taxable under the respective head of income.

Do Not Affect Capital Structure:

o These receipts do not change the capital or liabilities at all shown in the balance sheet.

Figure 2.2

Examples of Revenue Receipts:

• Operating revenue from sale of goods

• Professional fees received

• Commission and brokerage

• Interest earned on bank deposits

• Income derived through letting of property

• Grants for operational costs

Government grants and subsidies are generally viewed as revenue receipts where received to cover working capital deficiencies or expenses.

Correct identification of revenue receipts enables correct calculation of income, right payment of rates and proper financial reporting. Misclassification may lead to inaccurate tax receipts, which will make you liable to penalties and interest.

2.4.3 Distinction between Capital and Revenue Receipts

receipts to be distinguished

The concept of capital receipts and revenue receipts is vital for the proper computation of income in terms of taxation as well as accounting. This categorisation affects the tax treatment, income calculation, and financial reporting.

Key Points of Distinction:

Impact on Assets/Liabilities:

o Capital receipts alter the structure of the assets or liabilities.

o The capital structure is not affected by revenue receipts.

Source:

o Capital receipt is the result of non-operational transactions.

o Revenue Receipts: These are related to business operations.

Examples of Overlap:

o Sometimes, classification may be disputed. Compensation received, for instance may be of capital or revenue nature depending on the use S.--75(4) thereon (loss of source vis-a-vis loss of income).

It has been consistently laid down by the judgements that we must go by substance of a receipt and not its form or nomenclature - CIT Vs. P.K.Narayana Pillai - [2006] 280 ITR 106 (SC). Classification is important to getting it right and avoiding disputes with tax authorities.

2.4.4 Taxability of Capital vs Revenue Receipts

Whether a particular capital and revenue receipts are taxable or not depends on whether the charging sections of Income Tax Act include them or not. Generally terms, most receipts of revenue are taxable by operation of law, while all capital receipts become chargeable to tax only if they are expressly included in the Act.

Taxability of Capital Receipts:

• Capital Receipts Not Chargeable Even Without Exemption: Capital receipts are not charged to tax, unless they are specifically included in the definition of total income.

• Exceptions (Taxable Capital Receipts):

o Capital gains on transfer of capital assets[Section 45].

o Deemed income as per Section 56(2) – e.g., gift of immovable property.

o Compensation on termination of rights or compulsory acquisition.

• Non-Taxable Capital Receipts:

o Lending or borrowing (with TDS)

o Capital contributions

o Sale of personal effects (such as household furniture)

Taxability of Revenue Receipts:

• Always Taxable, unless:

o Exclusive exempt under Section 10 or others.

o E.g., Agricultural income [Sec 10(1)] Share of profit in a firm [Sec 10(2A)].

Special Situations:

• Grants/Subsidies:

o If in respect of the acquisition of assets – it is a capital receipt (not charged to tax).

o If for day to day expenditues Revenue receipt (taxable).

• Compensation:

o Incase of loss of profit –revenue (taxable).

o For Loss of Capital Asset – capital (tax as) gains).

Understanding taxability is important for:

• Complying with return filing provisions.

• Financial planning and minimizing effective tax cost.

• Avoiding under-reporting of income.

2.4.5 Examples and Case Law Applications

The identification and characterisation of capital vis-a-vis revenue receipts forms an area of wide judicial interpretation. To sort out the classification, the courts have established a number of principles.

Examples:

Capital Receipt:

o Sale of Land: Money is capital receipt; taxable under the head “Capital Gains”.

o Partner’s Capital Contribution: Tax-free receipt of capital in the firm.

o Loan from Bank: Capital receipt; not taxable; unless written off.

Revenue Receipt:

o Consulting Fees: Ordinary income; fully taxable.

o Letting out of Commercial property: Taxed under ‘Income from House Property’.

o Interest from FDs: Taxable under “Income from Other Sources”.

Case Law Applications:

CIT v. Saurashtra Cement Ltd. (2010):

o Compensation for delay in establishment of plant held to be capital receipt.

Kettlewell Bullen & Co. Ltd. v. CIT (1964) 53 ITR 261 (SC).

o Compensation for loss of agency business treated as revenue receipt as it provided compensation in future loss of profits.

Travancore Rubber and Tea Co. Ltd. v. CIT (2000) 244 ITR 764 :25889:

o Subsidy for replantation received was held to be capital receipt.

CIT vs Rai Bahadur Jairam Valji (1959):

1) Compensatory payment for loss of source of income is capital receipt.

Cadell Weaving Mill Co. Pvt. Ltd. v. CIT (2001):

o Gifts in the hands of a person other than his relative was considered as income from an authorised representative (AR) which were subsequently overruled by Section 56(2)(v) and explanations thereto.

These examples serve as a reminder that the basal construal of both offers and tenders is contingent on:

• Purpose of receipt

• Effect on the earning machine vs cashflow

• Whether the receipt is of income or capital

So, the Courts are indispensible for binding and interpreting the law uniformly.

Knowledge Check 1

Choose the correct options:

1. Which of the following is a capital receipt?

a) Sale of goods

b) Interest income

c) Loan from bank

d) Rent received

2. Revenue receipts are usually:

a) One-time

b) Non-recurring

c) Operational income

d) Shown in balance sheet

3. Which of the following is not taxable as capital receipt?

a) Sale of machinery

b) Gift exceeding ₹50,000 from friend

c) Partner's capital contribution

d) Compensation for land

4. Grants received for working capital support are:

a) Capital receipt

b) Revenue receipt

c) Non-taxable income

d) Balance sheet item

5. Which case held compensation for loss of business agency as revenue receipt?

a) Saurashtra Cement

b) CIT v. Rai Bahadur Jairam Valji

c) Kettlewell Bullen

d) Travancore Rubber

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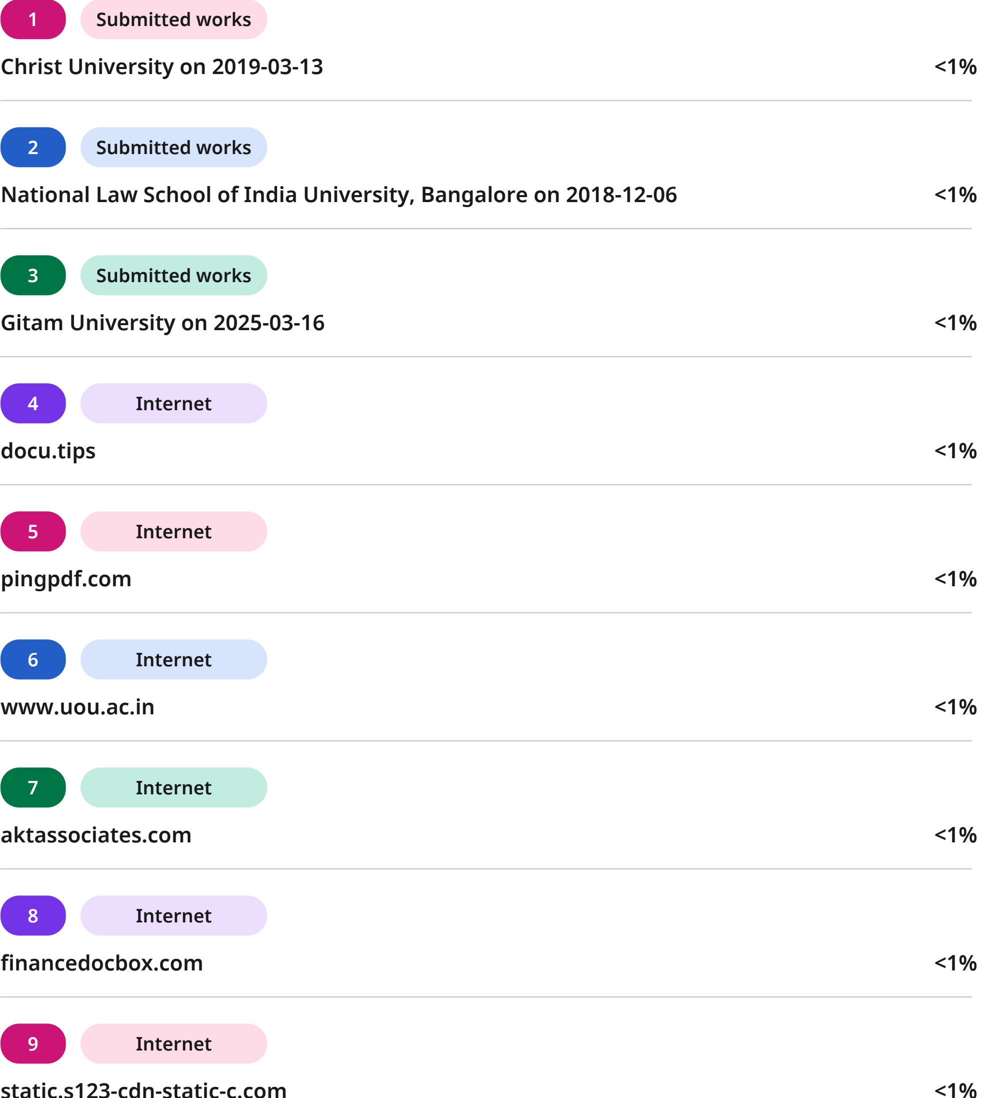

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Unit 3 Scope of Income & Residential Status

Learning Objectives

1. Define residential status as per the Income Tax Act and explain its significance in determining tax liability.

2. Differentiate between Resident, Resident but Not Ordinarily Resident (RNOR), and Non-Resident (NR) categories for individuals and other entities.

3. Apply the basic and additional conditions to determine the residential status of an individual under Indian tax laws.

4. Explain the concept of scope of income and how it varies depending on the residential status of the taxpayer.

5. Classify incomes as Indian-sourced or foreign-sourced and analyze their taxability based on residential status.

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3.0 Introductory Caselet

"Ankit's Global Income Dilemma"

Software engineer Ankit Sharma hails from India and has been employed with a multi-national IT company since the last six years. For FY 2024-25, Ankit was in India for 110 days and the remaining period was spent in Germany where he worked. While he was abroad, he received a monthly remuneration deposited into his German bank account. Also, Ankit has a residential house in Bengaluru which he has given on rent for Rs.

₹35,000 per month. The rent is transferred automatically into his Indian bank account.

Ankit also invested in U.S.-domiciled stocks for which he received dividend income. The dividend income was deposited in his U.S. brokerage account. Additionally, he was also sending a part of his German earning to take care of his parents in India.

At the end of financial year Ankit needed to file income tax return in India. He consulted with a tax professional to find out:

• Residential status for the previous year 2025–26

• Whether his Indian and foreign income from various sources are taxable or not; and

• If he is taxable in India on overseas salary and dividends earned

Critical Thinking Question

I would like you to advise how do you find out the residential status of ankit and also which income is taxable in India under facts given above. Explain your answer with reference to the relevant provisions of the Income Tax Act.

3.1 Total Income and Its Classification

3.1.1 Introduction to Total Income under the Income Tax Act

What is Total Income in the context of Indian Taxation? It is the amount on which your tax liability is decided in the particular financial year. Total income isn't a gross number, it's a net number that flows through after all of the rules under the Act have been meticulously applied. It is a step-by-step mechanism for the calculation of all income governed by the statute of an assessee (which may be, an individual, or any entity) with regard to his or her total income after considering exemptions, deductions and the effect of brought forward and set off losses.

Income earned in a particular financial year is known as the Previous Year, and the year in which it is charged to tax is known as the Assessment Year for income-tax purposes. For instance, say the income of a financial year ie 2024–25 (April1, 2024 to March31, 2015) is earned then it will be assessed in AY 2025-26. This differentiation between the two years is very important for tax calculation and filing.

Also on the next date of hearing, we shall find out the residential status of assessee under section 6ofthe Act, which has to be computed before we commence computing total income. As the total income is determined under Section 5 of the Income Tax Act, depending on whether the assessee is:

- Resident and Ordinarily Resident (ROR)
- Resident but not ordinary resident (RNOR)
- Non-Resident (NR)

The liability of the income earned outside India is taxable based on one's residential status. For a ROR, the total income received from all sources in India (liable as per section 5) and outside India is to be taxed for the AP in India. The incidence of Tax on Non-Residents and RNOR is limited to the income:

- Having been received or having accrued in India,
- Accrues or arises in India, or
- Is/was a residence in India 12,That accrues or arises, directly or indirectly through other foreign companies which) some profit is not if it would still have been regarded to accrue or arise relative to) be so deemed to accrue or arise.

It follows that residence status is the first limb in the quantification of income tax.

We here go over few important components of the calculation of total income.

Then after determining the residential status, total income has to be computed as per the provisions of the Act. The calculation is elaborate and is built up from the following crucial elements:

• Income Under Five Heads (Sec. 14)

The Income Tax Act groups the income under five major heads, which enables systematic calculation and also simplifies the application of particular provisions such as allowances, exemptions etc. These are:

Salary: This heads covers basic salary, allowances, perquisites, gratuity, pension and leave encashment or any other benefit received by a person as an employee.

House Property: Rental income or deemed rent from owned property, after applying standard deductions.

Profits and Gains from Business or Profession: Comprising profits earning from trade, professional income, free lancing etc.

Capital Gains: Earnings from the sale or transfer of capital assets such as land, buildings, shares and others being either short-term or long-term.

Income from Other Sources: Residuary head covering income not included in the above, e.g., interest income, lottery winnings or dividend income.

All of these heads have special rules in relation to perquisites, deductions and the manner of computation and proper classification is necessary for proper determination of tax liability.

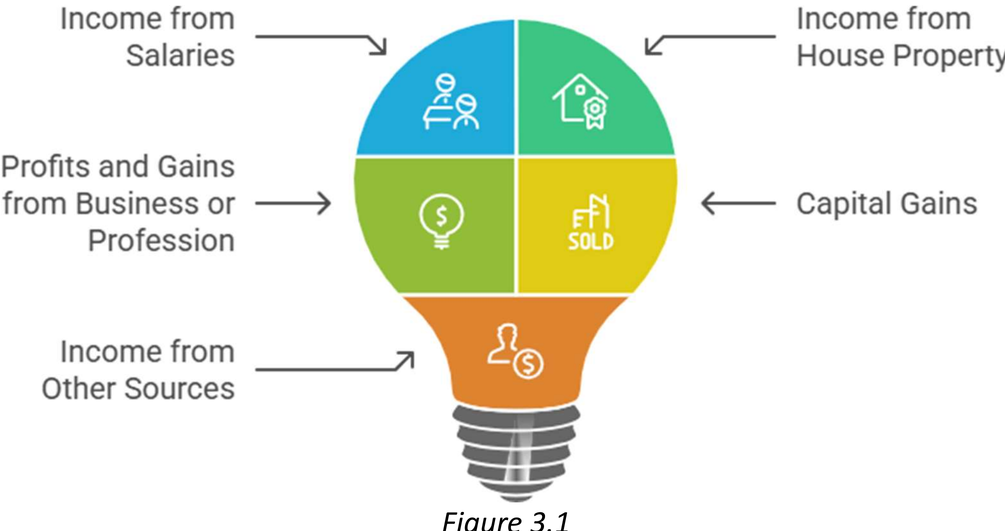

Figure 3.1

• Clubbing of Income

To curb tax avoidance concerns from income splitting, the Act requires certain incomes to be clubbed. In such a situation, the income received by another person (which is legal) will be added to the assessee's income only when:

• Assets are given to a spouse or minor child without exchange of fair value.

• Funds are earned from investment of transferred funds or indirectly.

Illustration: In case a husband gives money to his spouse and the same is invested by her in fixed deposits, such interest income may be clubbed with total income of the husband.

The purpose behind this provision is to prevent misuse of tax slabs and exemptions by allocating income at lower tax brackets amongst family members.

• Set-off and Carry Forward of Losses

Losed treatment is other essential aspect of the income's calculus. The Act permits the assessees to set off losses borne under in certain heads of income against income from other head, subject to specified conditions.

There are two mechanisms involved:

Adjustment of losses: Losses from one source can be set off against income arising from another source in the same year (subject to conditions of intra-head and inter- head set-off).

Carry Forward of Losses: Under the current regime such Losses which could not be set-off in the same year due to lack of profits can be carried forwarded for set-off against profits in future assessment years.

Example: Business loss can be carried forward for 8 years and set off against business income in the future.

It's a way to keep from hammering taxpayers who end up in financially short-term hardship and are leveraged later on net positive income.

• Section 10 Exemptions and Chapter VI-A Deductions

The Act contains a number of exemptions and deductions in order to arrive at the taxable income of the assessee.

Exemptions (Section 10): Some kinds of income are either wholly exempt or partially exempt from tax. These include:

o Agricultural income

o Share of profit in the partnership firms

o Certain allowances and perquisites

o Scholarships and awards

Deductions (Chapter VI-A, Sections 80C to 80U): Taxpayers will be able to claim deductions on amounts spent or invested on the following categories:

o Premiums paid for life insurance and investments in ELSS (Section 80C)

o Health insurance premiums (Section 80D)

o Educational loans interest (Section 80E)

o Contributions to charitable institutions (Section 80G)

These benefits encourage savings, welfare (social), education and medical service based on behavior in a tax-incentive way.

• Rounding up of 'Total Income' (Section 288A)

Under Section 288A, once total income is calculated, it should be rounded off to the nearest ₹10. The rounding rule is simple:

• If the last digit is ₹5 or greater, round up.

• Round up if the last digit is \ 5 or higher.

This uniformity eliminates confusion and makes it simpler for taxpayers to file their taxes.

3.1.2 Five Heads of Income (Section 14): Overview

Computation of Total Taxable Income As per the Indian Income Tax Act, 1961 the structure to arrive at total taxable income in respect of an assessee is detailed. The nucleus of this structure is section 14, classifying the entire income of a taxpayer under five separate heads of income. This distinction is vitally important as each head has its own computation rules and deductions, allowances and exemptions. The law divides income into these five heads, so that every kind of income is treated equally and taxed uniformly. Second, categorization of income under its relevant heads is an important first step for computing total income and hence determining tax assessed thereon.

The five 'heads of income' referred to in Section 14 are these:- I.

• Income from Salaries

This heading is relevant where there is a contractual employer-employee relationship. Payments made to employee as perquisites or benefits are taxed under this head. It includes a variety of components falling under income such as basic salary, dearness allowance, house rent allowance (HRA), bonus, gratuity, pension and perks including rent-free accommodation or use of company car.

Any income tax on employment-related earnings is deducted in a manner that takes into account deductions common to both employer and employee, as well as for specific exemptions such as HRA or leave travel allowance under Section 10.

• Income from House Property

Income under the head is computed on the basis of ownership of property including buildings or land appurtenant thereto. It does not matter whether the property is leased or not. Sometimes, the owner may need to pay tax on notional rent even when no actual rents has been received (for example, a property given on rent was vacant for a long time).

The Act makes provision for certain deductions from income for this head including a standard deduction of 30% in lieu of repairs and maintenance with interest on borrowed capital being permissible as a deduction under section 24(b) making this head unique to deal with passive property based income.

• "Profits and Gains of Business or Profession.

This head includes income from the pursuit of any business, vocation, trade or profession. It is apolitical on those individuals, firms, LLPs, companies and others. The income under this head is determined after deduction of all admissible expenses which were incurred wholly and exclusively for the purposes of business or profession.

Expenditures in this category would be wages to employees, rent for business space, wear and tear and obsolescence (depreciation) on equipment or buildings, and interest on loans used to finance the operations of the business. This head is indicative of operational income and would generally involve more compliance with documentation and rule changing record-keeping like maintenance of books and an audit under Sections 44AA, 44AB etc.

• Capital Gains

This head deals with income from the sale of a "capital asset" It means any asset which you own like land, building, shares, bonds, mutual funds etc. The gain is will then be calculated as follows: Sale Poetry $ The second number (amount) below shows the gain, in which you can increase during preparation for financing a new public offering.

proceeds and cost of acquisition (adjusted for improvements and inflation, if any). The gain is classified as short-term or long-term depending on how long the asset has been held.

LTCG are generally allowed indexation and taxed at a lower rate, but STCG tax is based on the slab rate or fixed rate depending upon the kind of asset. Exemptions could also be claimed under specific sections – 54 (on reinvestment in residential property), or 54EC (investment in specified bonds).

• Income from Other Sources This is a residual head, designed to capture income that is not covered under any of the four heads above. It includes a wide variety of income such as interest on savings bank/fixed deposits, dividends, winnings from lotteries or games, gifts

received beyond a certain limit, and the family pension. The importance of this head lies in its catch-all nature – no taxable income should escape assessment just because there was no alternative head to classify it under. Specific provisions u/s 56 spell out the scope, exemption, and tax treatment of such miscellaneous income. Each of the above heads has its own computation provisions which must be adhered to. In addition deductions u/s VI-A, which are typically applied only after income on a heads basis income has been classified and computed. The last total income in the hands of the assessee is the sum total of income by all heads after accounting for loss adjustment and the deduction admissible. Classifying income correctly under the relevant head is primarily crucial for accurate tax computation. Additionally, it also ensures proper deductions may be availed and prevents the assessee from bearing penal consequences for erroneous reporting. For example, mis assuming professional fees for salary would render the assessee not eligible to the deduction of expenses incurred in the course of business. Misreporting of gains from equity shares and mutual funds could also result in an incorrect tax rate application.

3.1.3 Income Exempt from Tax vs Taxable Income

The income earned by a person or organization may be exempt from tax or fully/partially taxable, as per provisions of the Income Tax Act. The difference is important in order to correctly compute taxable income and receive all applicable tax breaks.

Exempt Income:

Exempted income -Income that is not considered in the calculation of total income and not taxed. These incomes are mainly dealt with under section 10 of the Income tax Act. The types of income that are generally exempt are:

• Agricultural income (Section 10(1))

• Share of profit of partner from a partnership firm (Section 10(2A))

• Long-term capital gains arising from sale of Equity Shares (Section 10(38) – but restricted now)

• Some government employee allowances and perquisites

• Scholarships given to students (Section 10(16))

• Maturity benefits from life insurance (to the extent not subject to tax under Section 10(10D))

While these receipts are exempt from tax, one may be required to report (disclose) the same in the income tax return in exempt income schedule.

Taxable Income:

Taxable income is the sum of all incomes that are taxable (or chargeable) computed under each head. These are then decreased by permitted deductions, rebates and reliefs to obtain the net tax liability.

Income is categorized by considerations such as source, length of holding (in the case of assets), or character.

recipient and the nature of the recipient (a person, a company, etc.).

Distinctions Between Taxable and Non-taxable Income:

• Reporting Obligations: Exempt income may need to be disclosed in one's tax return, even though it is exempt from tax, yet taxable income must be fully reported and taxed according to the rates that are applicable.

• Tax Planning: Knowledge of exempt income is essential for tax planning including purchase of products garnering returns that are not subject to tax.

Documentation and Evidence: Documentary evidence is frequently a prerequisite to justify an exemption claimed.

3.1.3 Income Exempt from Tax vs Taxable Income

Income of a person or entity can be exempted from tax or fully/partially taxed under the Income Tax Act. This distinction is important for accurate calculation of the income check and to ensure the receipt of all the proper tax breaks.

Exempt Income:

Exempt income means incomes which are excluded from the total income and are therefore not taxable. Such incomes are dealt in particular under Section 10 of the Income Tax Act. Some households' sources of income are exempt from consideration.

• Agricultural income (Section 10(1))

• Income from share in a firm (Section 10(2A))

• Equity shares held for long-term (Section 10(38) – but restricted now)

• Some entitlements and facilities for government servants

• Allowance to students other than those granted for the purpose of education (Section 10(16))

• Maturity of life insurance (conditions apply under Section 10(10D))

While these receipts may be tax-free, taxpayers might well be required to show them in the income tax return at specifically defined places.

Taxable Income:

Income on which tax is chargeable under the five heads of income mentioned in Section 14 forms the taxable income. Allowable deductions, rebates and reliefs are then applied to reduce TT before determining tax liability.

Segmentation of taxable income is made according to different criteria such as origin, length of possession (in the case of assets), and type.

natural person, company, firm or other entity to whom a message is addressed.

Exempt and Taxable Income Distinguishing between exempt income and taxable income is:

• Disclosure: Exempted income can be asked for disclosure in the tax return, but taxable income must be shown and taxed on @ of all applicable rates.

• Tax planning: Knowledge about exempt income comes handy while planning taxes like investment in tax free instruments.

• Evidence and Proof: Evidence in the form of proof is generally requested to justify the exemptions that are claimed.

Did You Know?

"Not all exempt incomes are permanently tax-free. Some exemptions come with specific conditions, such as limits, tenure, and usage restrictions. For example, the maturity proceeds of a life insurance policy are exempt only if the premium does not exceed 10% of the sum assured."

3.1.4 Gross Total Income and Deductions (Sec 80C to 80U)

Add all income under such five heads, it is known as “Gross Total Income” (GTI). It is an important figure as, on this rests the other deductions under Chapter VI-A of Income Tax Act, to get us down to Total Income.

Gross Total Income (GTI):

GTI = Aggregate amount under 5 heads

• Clubbed income, if any

• Adjustments for set-off of losses

– Other income which is exempt (since it does not form part of the GTI)

GTI is the base for taking deductions under Sections 80C through to 80U These deductions are not exemptions, but are fixed amounts that you can deduct from your GTI to arrive at an income figure on which tax needs to be paid.

Deduction under Chapter VI A -Section 80C to Section 80U:

• Section 80C: Deduction in respect of investments up to ₹1.5 lakh. Eligible instruments are LIC premiums, PPF, NSC, ELSS, principal repayment of home loan, tuition fees and others.

• Section 80CCC & 80CCD: Investment in pension schemes such as NPS.

• Section 80D: Premiums paid for health insurance of self and family (subject to specified limit according to age).

• Section 80E: Interest on education loan for higher studies.

• Section 80G: Deduction allowable on Donations to certain funds, charitable institutions etc.

• Section 80TTA / 80TTB: Interest on savings account and fixed deposits (80TTB for senior citizen).

•Section 80U: Deduction for the person with disability (amount varies according to nature of disability).

Key Points to Consider:

• The total limit under Section 80C, 80CCC and 80CCD(1) is ₹1.5 lakh.

• Section 80CCD(1B)-- Additional deduction of upto fifty thousand rupees for contribution to NPS.

• Deductions allowed only if investment/payment is proved.

Thoughtful deduction planning can result in substantial tax savings and should correspond to individual financial objectives.

3.1.5 Illustrative Classification of Incomes

Although the legal model of the five heads of income under the Income Tax Act provides a structured approach for classification, it is their practical implementation in real world which leads to better assimilation. Correct classification of income under the right head is a necessity not only for correct computation of tax but also to claim corresponding exemptions, deductions and rates. Following is a summary of the popular types of income and their inclusion under five heads specified under Section 14 of the Income Tax Act, 1961. These examples also show what type of income is subject to tax and what type is not taxable, under a particular provision.

Income from Salaries

This header includes all earnings from employment. Parts of compensation are taxed differently.

• Basic Salary:

Fully taxable as a part of gross wages. There are no waivers on this section.

Illustration: If ₹6,00,000 is the basic pay received annually then entire amount of ₹6,00,000 will be taxable.

• House Rent Allowance (HRA):

Partly exempt u/s 10(13A) based on certain conditions such as rent paid, city of residence and the nature of the salary.

Illustration: An employee receiving HRA of ₹15,000 a month may get partial exemption depending upon the rent paid and other factors.

• Leave Travel Allowance (LTA):

Exempt, subject to actual travel in India and submission of relevant proof. This had to be allowed for two visits in any four years.

Illustration: If employee claims LTA against domestic travel and furnishes travel bills, the same will be exempt.

• Gratuity Received:

Rendition under Section 10(10) — Exempt up to ₹20 lakh for non-Government employees. For government employees, it's 100 percent exempt.

Example: A private-sector retiree who is getting ₹18 lakh as gratuity will get full exemption.

These are just couple of examples which will make it clear that as a general rule the whole package is taxable but several allowances may be differently treated by the Act subject to certain conditions and limitations.

Income from House Property

Income under this head is derived from ownership of the buildings or lands appurtenant thereto, and in certain cases rent is tax- able irrespective of its receipt.

• Rental Income from Let-Out Property:

Taxable after deduction of standard deduction 30% under section 24(a) for repairs and maintenance.

For instance, where the annual rent amounts to ₹3,00,000; after 30% deduction on this amount only ₹2,10,000 would be taxable.

• Self-Occupied Property:

Annual value is deemed as nil for maximum two self-occupied houses. Beyond two, a hypothetical rent is calculated.

Illustration: An individual who owns one self-occupied flat in Delhi will have no taxable income under this head.

• Realized Rent Recovered Later:

So even the rent which has not been realised in some years can become taxable if it is recovered later, during the year in which it is received (section 25A), irrespective of whether the property is held or not!

Example: Old dues of a tenant received after 2 years to be offered in the year of receipt.

This head highlights that the basis of taxation is ownership rather than just receipt of rent and some notional incomes are also taken into account.

Income from Profits and Gains of Business or Profession

This heading concerns business or professional income, covering both regular business activities and freelance sub-areas.

• Income from Freelancing or Consultancy:

Business Income Taxable-business income deducting expenses incurred wholly and exclusively for the purpose of earning such income (b) 20%.

Illustration: If you are a graphic designer receiving ₹10 lakh through freelancer fees and spent ₹3 lakh on software and internet, ₹7 lakh is what you pay tax on.

• Depreciation on Assets:

Deductible under Section 32 investment on depreciable assets such as machinery, furniture, or computers used in business.

Example: A lawyer using a laptop for business purposes may deduct the cost through depreciation.

• Professional Receipts (Doctors/Lawyers/Consultants):

Prior to P.Y. 2017-18, income was chargeable to tax under the head “Profits and gains of business or profession” and they may also opt for presumptive taxation u/s 44ADA, if eligible.

Illustration: Where a doctor earning ₹ 40 lakh per annum, opts for computing his income on presumptive basis of 50% of the gross receipts.

This head refers to net profit after allowable business deductions, and will require maintenance of books of accounts and adherence to statutory requirements.

Capital Gains

Capital gains are triggered when a capital property is disposed for an amount greater than its cost. The tax rate is determined by the nature of the asset and how long it was held.

• After 3 years Place Residential House on Sell:

Treated as LTCG, and could be exempt under section 54 on reinvestment in another house.

Example: If a house is sold for ₹1 crore after 4 years having the indexed cost of ₹60 lakh, the LTCG will be ₹40 lakh and can be exempt if re-invested.

• Shares held for less than 12 months, but more than 1 month:

Treated as Short-Term Capital Gains (STCG) and taxed at 15% under Section 111A, if traded on recognized stock exchange.

Illustration: A profit of ₹50,000 on listed equity shares that has been sold within 10 months is subject to a tax at 15%.

• Agricultural land in rural areas:

Does not treated as a capital asset, so is not taxable under the capital gains.

Example: A farmland municipality sells its rural agricultural land, the sale is fully exempt from capital gains tax.

This head is especially important for real estate and tax planners because it also provides numerous exemptions and planning techniques.

Income from Other Sources

This is the remaining head, including income not covered under the other four heads. It ensures that

slip from various other non-recurring sources.

• Interest from Savings Account:

Taxable under this head, but deduction up to ₹10,000 allowed under 80TTA for individuals and HUFs.

Illustration: ₹7,500 of bank interest earned is completely exempt under 80TTA.

• Dividends from Indian Companies:

Usual rate of tax with shareholders (as no more Dividend Distribution Tax from 2020).

Example: The dividend received is of ₹20,000 than whole amount would be taxed.

• Gifts Received:

In case the gifts (in cash or kind) have been received for an amount exceeding ₹50,000 during any financial year, such amount becomes taxable u/s 56(2)(x), except where the same is received from a relative or on certain specified occasions like marriage.

Illustration: A ₹1 lakh gift on one's birthday from a friend is entirely taxable.

This is the head you need in place to adequately tax your casual income, windfalls and passive receipts.

Additional Considerations

Besides this two examples, there are two very important rules to bear in mind when classifying or computing the income:

• Clubbing Provisions:

If an assessee transfers income/proper-ty to his or her spouse or minor child, without adequate consideration, the income arising out of such transfer is liable to be clubbed in the hands of the transferor (assessee) under the relevant head.

Example: Interest on fixed deposit in the name of wife through funds provided by husband is commissionable to husband's hand.

• Set-off and Carry Forward of Losses:

Here's how to do that: Don't worry if you've lost money on one head but made some on another, though — because losses from one head can be "set off" against gains from the other, subject to conditions. However, business loss cannot be adjusted against one's salary and capital loss can be offset only against capital gains.

Example: The loss of ₹50,000 on sale of mutual funds (loss in capital) can be adjusted only against another gain under the head 'capital gains' and not against business income.

3.2 Determination of Residential Status (Individuals)

3.2.1 Pertinence of residence Status in Taxation

Residence 8.01 Introduction Residence is a basic concept of the Indian Income Tax Act, because it decides the extent of income which is taxable in India. The taxability of an individual's income, be it global or Indian source, is determined based on his residency status, either as a Residentor a Resident but Not Ordinarily Resident (RNOR) or a Non-Resident (NR). This categorization is prescribed by Section 6 of the Income Tax Act, 1961.

For example, a Resident and Ordinarily Resident (ROR) is taxable on worldwide income, which would include income earned or received outside India. On the other hand, a Non-Resident (NR) is taxable only on income that was earned/received in India. The situation for RNORs is somewhere between the two - they have partial world taxability.

Tax compliance like filing tax returns, disclosure of foreign assets and application of TDS provisions also depends on residential status. In addition, tax treaty benefits, exemptions and deductions can differ based on the individual's residency.

Areas of Analyses -Residential Status – Results have taken effect in:

- Ambit of Total Income (Section 5)
- Taxability of Foreign Income
- Reporting of Foreign Assets
- Higher TDS Rates or Surveillance Where a higher rates of TDS or surveillance is applicable.
- Qualification for Deductions in respect of Chapter VI-A

It is, therefore, important to capture the residential status correctly at the inception of the assessment proceedings in order to calculate the taxable income properly and comply with statutory obligations as per Indian Tax Laws.

3.2.3 Additional Conditions of RNOR vs ROR

After a person is classified as a Resident under Section 6(1), he may either be classified as ROR (Resident and Ordinarily Resident) or RNOR (Resident but Not Ordinarily Resident) depending under the sub-section 6(6) of the Income Tax Act.

An individual is considered ROR if both the conditions are fulfilled: Note.- An assessee, who is non-resident, shall not be of above clause.

additional conditions:

the individual has been a resident in India for at least 2 out of 10 previous years immediately prior to the relevant previous year; AND

He has been in India for at least 730 days or more during the preceding seven years

immediately preceding the relevant earlier year.

If either one of these two tests is not met, the person will qualify as a Resident but Not Ordinarily Resident (RNOR).

Importance of RNOR Status:

RNOR is an intermediary residential status between that of a resident and a non-resident in India. It offers tax relief by:

- Taxing income only if it is earned in India (not abroad), unless earned from a business or profession that operates control from India.

• Relaxation on laws governing reporting and taxation of foreign assets and overseas bank accounts under Black Money Act.

This is especially advantage to returning NRIs, expatriates and people with overseas income.

Additional Considerations:

• RNORs do not have to pay tax on interest earned from NRE/FCNR accounts, however RORs need to.

•RNOR status is usually available for 2–3 years after returning from abroad, this depends on the number of days stayed overseas.

And careful record-keeping of your residential history is critical to figure out ROR vs RNOR and get the best tax treatment.

Overall Illustration: Whether to be deemed as ROR or RNOR.

Let assume a detail case of Mr. Sameer Desai (name changed), an Indian national residing and working in UK since 2014. He chooses to settle in India for good by October 2023. So for the financial year 2024–25 (FY 24-25) (AY 25–26), let us see whether Mr. Desai will be considered as ROR / RNOR.

Here is his travel and living history:

• He entered in India on 1.10.2023 and remained throughout the Indian Union upto 31.3.2025.

• During previous year 2024–25 he stayed for a full year (365 days) in India.

• His visit to India during the 7 previous years of ETA 2024–25 is as follows:

o FY2017–18 to 2023-24: He visited India for short durations in few.

♣ 2017–18: 20 days

♣ 2018–19: 0 days

♣ 2019–20: 25 days

♣ 2020–21: 30 days

♣ 2021–22: 20 days

♣ 2022–23: 15 days

♣ 2023–24: 180 days (he came back in October 2023)

⇒ Total days of stay in India during 7 previous years =290 days

Now let’s consider the two other conditions under Section 6(6):

• Test 1: You are resident in Ireland for any two of the previous ten tax years

He being non-resident during FY 2014–15 to FY 2022–23 (foreigne throughout) and has become resident in India only for the first time in FY 2023–24, he fails to fulfil this requirement. He has resided there only 1 year in the last 10 (2023–24).

• Condition 2: Was in India for 730 days or more during the last seven years

Running the numbers above, Mr. Desai has spent only 290 of the 7 years prior to 2024–25 in India. He fails therefore to satisfy this requirement as well.

Conclusion:

As Mr. Desai does not satisfy the aforesaid two additional conditions, he is RNOR for FY 2024-25.

Tax Implications on Mr Desai as RNOR :

• His UK salary and investment income will not be subject to Indian tax provided the income is not received in India or does not accrue from a business controlled from India.

• Interest on his NRE and FCNR accounts will continue to be tax free, which is not the case if he is an ROR.

• He will also not have to disclose in his Indian tax return (Schedule FA) any bank accounts maintained in the UK and assets held there.

After 2–3 years, wherever applicable (based on how long he stays in India), but the level of filtering may also be determined by his being a ROR then his global income would become taxable and there would be reporting requirement.

3.2.4 Non-Resident: Conditions and Rules

For eligibility, an applicant will be said to be a Non-Resident (NR) in case he/she doesn't fulfil any of the following fundamental requirements whence..

Subsection 6(1) of the Income Tax Act. This means:

• They were not in India for 182 days or more as per the preceding year. AND

• They were not present for 60 days during the year in question AND not resident in the preceding four years – namely a residence test at S3A FA 203.

This status is applicable for:

• Indian citizens working abroad

• Foreign tourists visiting India for a short period of time

• Ships crew member outside the Indian limit for a long period

Scope of Taxation for Non-Residents:

Only the below mentioned incomes are taxable for a Non-Resident in India:- िकेवly1.

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Income which is received or is deemed to be received in India.

Income which accrues or arises, or is deemed to accrue or arise, in India.

(i) Income in the form of salary; from property situated in India; capital gain on sale of Indian assets, interest on Indian bank accounts etc.

Special Provisions:

• NRIs need not to file ITR in India when there is only investment income (TDS deducted in every transaction) How NRIs Filing Taxes Can Avail Tax Deduction?

• They are entitled to benefits under tax treaty i.e. DTAA.

• Elegible other income is taxed at special tax rate (e.g. 20% for royalties, 15% for dividends).

It is imperative to correctly determine the NR status as it brings down tax liability and compliance load substantially.

Complete Example: Are you “non-resident?” What are the tax implications?

Let us consider the example of Ms. Ananya Kapoor, who is an Indian citizen employed in Canada in 2021. She last visited India in FY 2024-25 for a short trip and she wants to figure out if she is a resident of India in that year. She has been held at the following location:

• Date of Arrival In India: 1st December,2024

• Date of leaving India: 15th January, 2025.Required (i) Write a Partnership Deed.

→ Period of stay in India during the F.Y. 2024-25 = 46 days In the 4 preceding previous year, her visits to India were as follows :

• 2023–24: 40 days

• 2022–23: 35 days

• 2021–22: 50 days

• 2020–21: 60 days

→ Total stays in 4 years before = 185 days

So, now that we’ve concluded section 6(1), let us consider her position under the sub-section:

•She wasn’t in India 182 days of during 2024–25 — only for 46 days.

• While she was in India for more than 60 days in 2024–25, she was not there for at least 365 days during the four years before — not even close, only a total of 185 days.

As she does not fulfil the two primary criteria, Ms. Kapoor becomes a Non-Resident for the financial year 2024–25.

TAX IMPLICATION ON MS. ANANYA KAPOOR (AS NON-RESIDENT):

• Her foreign salary income earned in Canada will not be taxable in India since it is neither received nor accrues in India.

• She has a flat in Mumbai which is rented out. The rental income will be taxed in India, as it accrues from an Indian source.

• She holds a Non-Resident (External) account on which she earns interest on deposits — this is taxed exempt under extant laws.

• She has dividends credited against Indian stocks held in her Demat account. The dividends are taxable, and though TDS is deducted, if there is no other income she may not have to file a return.

• She can avail of DTAA relief if any part (example interest from India is already taxed in Canada) of her income is also included in their income in the second country.

Educational: As a Non-Resident Ms. Kapoor is liable for tax in India on India source income only and does not have to declare income earned abroad, foreign bank accounts or other assets in the return of income filed under the Indian Income-tax Act. She also enjoys simplified tax return filing, minimization of tax liability and the possibility of availing relief under DTAA (if applicable).

Knowledge Check 1

Choose the correct options:

1. An individual must stay in India for at least how many days to satisfy the first basic condition under Section 6(1)?

a) 60 days

b) 90 day

c) 182 days

d) 365 days

2. RNOR status applies when which of the following conditions is not fulfilled?

a) Stay in India > 730 days in 7 years

b) Resident in 2 out of 10 years

c) Global income earned

d) Indian citizenship

3. Which category is taxed on global income?

a) RNOR

b) Non-Resident

c) ROR

d) Seafarer

4. An Indian citizen visiting India is considered Resident if their stay exceeds 120 days and income in India is:

a) More than ₹10 lakh

b) More than ₹15 lakh

c) Less than ₹2.5 lakh

d) Taxable outside India

5. Deemed resident rule applies when:

a) Income from foreign assets is nil

b) Person has dual citizenship

c) Not liable to tax in any other country

d) More than 60 days in India

3.3 Residential Status for Other Persons

3.3.1 HUFs: Control and Management Test

The residential status of a Hindu Undivided Family (HUF) under the Income Tax Act is determined on the control and management of its affairs but not based upon physical presence or stay. This is provided for in section 6(2) of the Act.

An HUF is resident in India if the control and management of its affairs are, during the course of any previous year, situated wholly or partially in India. In cases where the control and management are entirely outside India, such HUF is deemed to be a Non-resident.

By "control and management" is meant the power of decision making and conduct of principal business of the HUF. 'This is the headquarters where decisions at a strategic and policy level are made - [not] matters of operational routine. It is carried out by Karta, who is the senior most member of family and by other senior members.

Classification within Residents:

Further, if an HUF is Resident the same can be classified as:

- Resident and Ordinarily Resident (ROR) or
- RNOR: Resident but Not Ordinarily Resident

This categorization is based on the position of the Karta. In case the Karta of the HUF satisfies the testys under Section 6(6) viz., within 2 out of last ten years, he has been a resident and within seven years immediately preceding that year he has stayed in India for at least 730 days, then such HUF becomes ROR. If not, the HUF becomes RNOR.

Additional Points:

- It does not really matter where HUF's bank accounts are, where its properties or business establishments is situated. All this revolves around control and management.

- A HUF will be resident if it has a partial control in India.

It's very crucial to know the control and management test, in case of an overseas HUF or if you have parents not residing with you.

NRIs, who are Kartas, whether they have to pay tax on their income worldwide and relevance of other compliance rules.

3.3.2 Firms and AOPs: Residency Rules

Partnership Firms and AOP (Association of Persons): Residential status is determined by its 6 (2) section of the Income Tax Act, which applies in case of BOIs (Bodies of Individuals). The test is that of control and management, which is the same as the rule in case of HUFs.

AOP or a firm is Resident in India if the control and management of its affairs is placed, wholly or partly, in India at any time during the previous year. In case the control and management is situated entirely outside India, this entity is deemed alien.

Key Elements of the Rule:

• Control and management should be relevant to the main decision-making issues in business.

• Locus of control runs with the location of board meetings, book of accounts and policy decisions.

• Residential status of partner or member is not regarded as a residential status of the firm/AOP.

Unlike people, companies and AOPs do not have the sub class as Resident or Ordinarily Resident (ROR) or Resident but Not Ordinarily Resident (RNOR). They are identified as Resident and Non-Resident.

Additional Observations:

• If a firm is in partnership and operates within India but manages by the persons from outside India, when decisions are made in within India then such firm will be considered as Resident.

• Limited Liability Partnerships (LLPs) are subject to a different statute and taxed like partnership firms and follow the residency rules.

• Once an individual is considered resident for tax purpose, then extent of the chargeability to tax on world wide income, availment of benefits under Double Taxation Avoidance Agreement and.

withholding obligations on cross-border payments.

The proper ascertainment of residency in respect of such entities, therefore, becomes necessary to determine the extent of their income taxable under Indian tax laws particularly when firms carry on business across different countries or receive income from foreign sources.

Place of Effective Management (POEM) for Companies 3.3.4

The Place of Effective Management (POEM) rule was first introduced to prevent companies, incorporated in foreign jurisdictions while controlling operations from within India, from evading taxes. POEM was incorporated in the Income Tax Act by Finance Act, 2015 and effective from A.Y. 2017-18.

As per Section 6(3) of the Act, a foreign company is deemed to be Resident in India where- POEM of such company being in India at any time during the previous year.

Definition of POEM:

According to the circular issued by the CBDT,POEM is “a place where such persons' are, in substance, making and formulating key management decisions that are necessary for the conduct of the business as a whole”.

Key Tests for POEM:

Place of board meeting: In case meetings are conducted in India and the decisions are made, one can infer that POEM is in India.

Role of Indian Residents: If the POEM and senior management or other top executives guiding strategic decisions are based in India, it adds to the case for Indian POEM.

Control by Parent Company If an India based parent company exercised control over a foreign subsidiary, and all key decisions in that business taken by Indian parent the POEM may lie in India.

Delegated Authority: “If only directorship and pell-pellax pigs over here are just ratifying what is taken by the Indian managers then POEM should be held as in India.

Exclusions:

• POEM provisions do not apply to companies whose turnover or gross receipts are less than INR 50 crore in a financial year.

• POEM is not to be decided on account of day-to-day operational decision but on the basis of strategic decision making.

Consequences of POEM:

• If the above-mentioned foreign company is treated as Resident based on POEM, it will be liable to pay tax in India on its worldwide income.

• There could be risk of transfer pricing regulations, minimum alternate tax (MAT) and other compliances being levied on the company.

Description of POEM: POEM is an effective substance-over-form test which is a factual analysis by the business; it requires documentary evidence like minutes of meeting, board resolutions or patterns of control.

3.3.5 Case Examples and Practical Scenarios

It becomes more apparent at this point, what the residential status of various categories of taxpayers is, by applying them to practical cases and real-life examples. Here are a few examples to make this clear.

Case 1: HUF with Karta Abroad

An HUF with Karta – Mr. Sharma has been living in UK for past 5 years. But the final investment decisions and family confabulations are reserved for these annual visits to India. There is not complete control and management in India. Thus, the status of HUF will be Resident in India.

Case 2: Firm in Dubai, Commanded fro India

XYZ Partnership Firm does retail business in Dubai, but the partners are based in Mumbai and all strategy making, accounting is done and even meeting of partners takes place at their Mumbai premises. As the control and management is in India so it will be a Resident Firm.

Case 3: India Controlled Foreign Company

Q18A Assume the following facts: ABC Ltd Singapore is a subsidiary of an Indian company. The board of directors convenes in Delhi, so too are all major decisions ratified by the Indian collective. In light of the above, the POEM can be said to be in India and ABC Ltd. may be considered as a Resident Company charged to tax on its worldwide income.

Case 4: An Indian Company Outside India

PQR Ltd., an Indian enterprise, has its operations in Africa and none of its business activities is carried out in India. But since it is also resident of India, then it is regarded as Iindian resident company and has to pay tax on world income.

Case 5: NRIs as a Person Controlling the Foreign Company

Two NRIs have formed a company in the UAE. All the decisions are being made outside India, and there is no Indian control there. Firm in this situation is Non-Resident hence, if it has any income in India then only such income (or portion thereof) shall be taxable.

These cases illustrate the application of residency rules in practice and underline the need for substance in international tax planning.

3.4 The Incidence of the Tax by Residential Status

3.4.1 Sec 5: Scope of Total Income Based on Residential Status

Residential status and scope of total income Under the Income Tax Act, 1961 Section 5 Subject to the provisions of this Act, the total income of any previous year of a person who is a resident includes all income from whatever source derived which (a)is received or deemed to be received in India in such year by or on behalf of such person; or (b)accrues or arises or is deemed to accrue or arise to him in India during such year; Do you need assistance filing his returns? It decides which income is taxable in India depending on whether the individual is a Resident and Ordinary Resident (ROR), Resident but Not Ordinary Resident (RNOR) or Non – Resident (NR).

If you are an ROR:

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

• Income which is received or deemed to be received in India, accruing or arising, whether directly through indirect source of income.

• Income which accrues or arises inside India (income received in India).This creates a situation where entire global income of an ROR is taxable in India.

For an RNOR:

• Incomes earned or which are deemed to have been earned in India

• Income which accrues or arises in India or is deemed to accrue or arise in India

• Income received or derived outside India would not be taxed unless it is from a business controlled from India or profession set up in India.

So the RNORs have some special global tax benefits. For a Non-Resident (NR):

• Income received or the deemed to be received in India.

• Income which accrues or arises, or is deemed to accrue or arise in India Any foreign income is fully exempt from the Indian Income-tax.

The legal form of Section 5 discriminates in favour of the residents, who have to pay but non-residents may not pay as their foreign income would be excluded from tax, and against the Indian resident whose global income is taxed. Section 5 also operates in combination with sections 6 and 9 to determine the taxability of income such as royalty, interest or salary earned outside India but received in India.

3.4.2 Income Received or Deemed to be Received in India

According to Section 5 (1) income is chargeable to tax in India if it is received or deemed to be received in India, during the previous year and it is irrespective of the residential status of assessee. So the phrase encompasses both actual receipt as well as certain situations where the law deems the income to have been received in India even if it has not physically come here.

Actual Receipt:

After the black money act: Income is taxable in India if it is either :

• Paid into a bank account held in India

• Payment by cash or cheque in Indian territory

• Brought into India from outside and empowered to be used in India.

For instance, any income which is directed to an Indian bank account by a foreign employer is deemed to be received in India and hence fully taxable, even for an NRI.

Considered to have been received in India:

Some of this income is deemed to have originated in India by legal fiction, regardless of where it was received. These include:

• Employer’s contribution to Recognized Provident Funds exceeding the specified limit

• You can do inter-account transfers from Unrecognized Provident Fund to Recognized Provident Fund

• TDS on income, TDS – Any sum of: any tax deductible at source (TDS) under section 195 and any tax collected at source in Soil the recipient’s income under section 198

The taxation of such deemed receipts prevents income from being avoided simply by reason of the method or time of transfer.

Taxability Based on Status:

• ROR: Taxable

• RNOR: Taxable

• NR: Taxable

That is why the income "received" or “deemed to be received” in India is taxed always, regardless of source or residential status of the taxpayer. This slab category ensures that any money which comes in the Indian tax net - like salary, rent, or commission — is taxable.

3.4.3 Income Accrued or Arising in India

All income accruing or arising whether directly or indirectly, through or from any business connection in India is taxable in respect of all categories of taxpayers - Residents, RNOR and Non-Resident. This is the idea that income is said to be received in, or earned situs of reception source, when it arises or originates in india although receipt may have taken place outside India.

Definition and Legal Meaning:

Explanation.- For the purposes of this paragraph, income shall be deemed to have accrued or arisen in India if it is, or arises directly or indirectly through or from any business connection in India. The source of income should be in India. This is so even if the contract or agreement resulting in the income is made outside India provided the source of income lies in India.

Illustrations of Income Accrues Or Arises In India:

- Remuneration received by an individual for services rendered in India
- Interest received from an Indian bank or a borrower
- Income from house property located in India It is important to note that the provisions related to Income from house property are not applicable to NRIs residing abroad.
- Gain on sale of shares or property in India
- Payment of royalty / fees for technical services to Indian resident providedIncome Royalties and fee for technical services paid from or by a Permanent establishment in India (PEI) unit.

This principle is in place to tax the incomes where India becomes a source jurisdiction. Taxability Based on Status:

- ROR: Taxable
- RNOR: Taxable
- NR: Taxable

Their income can be deemed as accruing or originating in India-even if the non-resident is providing consultancy services from a location outside India however the payer is based in India and the work is in connection with a project within India-and paid by an Indian entity.

The term 'deemed to accrue or arise in India' is also elaborated under section 9 of the Act and provides for indirect taxability of certain incomes like interest, royalties or even indirect transfer of Indian assets.

Accordingly, the Indian tax law conveniently casts a wide net of income sourced in India free from such resident-based personality peculiarities.

3.4.4 Foreign Income and Taxability for Different Statuses

Income parallel to foreign income would be an income earned or deemed to have been earned from a source outside India, not involving any Indian Operations/business connection. The taxability of such income depends upon residential status of the taxpayer as defined under Section 6 of Income Tax Act.

"And that is for the Resident and Ordinarily Resident (ROR) people:

• The ugly bit is that all foreign income (excluding on goods or services) is taxable, whether or not it is brought into India.

• These will include salary received overseas, rentals from property abroad, interest income from foreign bank accounts and capital gains on assets outside India

• RORs are also required to adhere to the overseas assets disclosure laws in cases of Black Money Act

Regarding RNOR:

• All of the following types of foreign income are taxable:

o If it is made from a company based in India,or

o If it's been received from a business or profession established in India

• Foreign income received purely for private-purposes (e.g salary, gifts, property rental abroad) are non-speculative in nature.

It provides partial relief from taxes to NRIs returning home or professionals with foreign-sourced income.

For Non-Resident (NR):

• No tax is paid on foreign earnings in India

• Only income that accrues, arises or received in India is taxed.

• Salaries, pension, dividends or rental income from outside India are excluded from Indian tax regime

Key Considerations:

• Double Taxation Avoidance Agreements (DTAAs) could offer relief by way of tax credit or exemption

• Income earned outside India and repatriated to India is not taxed again if tax was already levied in the foreign country and such income does not attract accrual rules of Indian IT Act

• Residents of India who have a foreign bank account or assets held overseas should declare those in the ITR if they earn more than basic exemption limit

Tax on foreign income is very vital for the structure of cross-border business or investment, Global Income Compliance, NRI taxation etc.

3.4.5 Summary Table of Tax Incidence for ROR, RNOR, NR

The following table provides a comprehensive overview of the tax incidence based on residential status under Section 5 of the Income Tax Act.

Type of Income	**Resident and Ordinarily Resident (ROR)**	**Resident but Not Ordinarily Resident (RNOR)**	**Non-Resident (NR)**
Income received in India	Taxable	Taxable	Taxable
Income deemed to be received in India	Taxable	Taxable	Taxable
Income accruing or arising in India	Taxable	Taxable	Taxable
Type of Income	Resident and Ordinarily Resident (ROR)	Resident but Not Ordinarily Resident (RNOR)	Non-Resident (NR)
Income deemed to accrue or arise in India (Sec 9)	Taxable	Taxable	Taxable
Income accruing or arising outside India	Taxable	Not Taxable, unless from Indian business	Not Taxable
Business/profession income from abroad controlled in India	Taxable	Taxable	Not Taxable
Salary for services rendered outside India	Taxable	Not Taxable, unless controlled from India	Not Taxable
Gifts received outside India	Taxable (subject to sec 56(2)(x))	Not Taxable	Not Taxable

This tabular classification is crucial for taxpayers, advisors, and professionals dealing with multi-jurisdictional tax matters. It forms the basis of return preparation, international tax planning, and compliance with both Indian and foreign tax laws.

"Activity: Real-Life Income Assessment Exercise"

In this activity, students will be given the profiles of three individuals with different residential statuses and income sources such as foreign salaries, Indian dividends, capital gains from foreign stocks, and rental income in India. Based on the details, learners must classify each income source as taxable or non-taxable under Indian tax law, citing the relevant provisions from Section 5. This exercise will strengthen practical understanding of tax incidence, build analytical skills, and improve application of legal rules in real-life tax scenarios.

3.5 Summary

- Residential status as per the Income Tax Act decides what income for each person and all entities is taxable in India.
- ϖ Section 6 of the Income Tax Act which provides as to who shall be considered resident, RNOR and Non resident.
- A Resident and Ordinarily Resident (ROR) is taxed on his world-wide income while a Non-Resident is only taxed on Indian Income had by him.
- RNOR are taxed on Indian as well as foreign income but only if such income is earned from an Indian-controlled business or profession.
- Section 5 of the Act, reads: "The total income shall include all income from whatever source derived whether received or accrued or arisen, comes abroad or is deemed to be received or accrued within Pakistan.
- HUFs, firms and AOP are categorized on the basis of place of control and management of their affairs.
- Companies are resident if they are incorporated in India or Their Place of Effective Management (POEM) is in India.
- POEM stands for the location where significant material corporate and commercial decisions are taken and implemented.
- The tax incidence is highly varied on different residential status involving the impacts on both compliance and liability.
- Foreign income is taxable to full extent in the case of RORs and not taxes for RNORs and NRs, subject to certain conditions.
- Flying in Indian citizens living outside India may provide provisions for determination of residence on income basis or number of days stay in India.
- Residential status is a fundamental prerequisite to do the correct tax treatment and comply with the law.

3.6 Key Terms

1. Resident - A person who meets the basic requirements as per section 6(1) for residence in India.
2. RNOR – A Not Ordinarily Resident but rnor definition of rnor; 3 rnr vide bhurb.

3. Non-Permanent – A natural person, who fails to satisfy the residence conditions in Section 6.
4. Total Income – This is the total amount of income that you've earn from your various sources after deductions and exemption.
5. Income Scope -What are the Income income that should be taxed in India on basis of Residential Status.
6. Control and Management – The place where key decisions of the organization are taken.
7. POEM – Place of Effective Management; which is used to ascertain the residency of foreign companies.
8. "Deemed Income" means, income which is to be treated as received or accrued in India by a legal fiction.
9. Accrued Income – Income which is earned or produced in some location for which no payment has yet been made.
10. Foreign Income – This is income from abroad, which is taxed depending on residential status.
11. Double Taxation – Tax of the same income tax in another country.
12. Assessment Year – The year next following the previous year in which the income is assessable and taxed.

3.7 Descriptive Questions

1. Discuss the test for residence of an individual under Section 6(1) of Indian Income Tax Act.
2. Explain the difference between Resident, RNOR and Non-Resident in relation to total income.
3. How does the residential status of an HUF (Hindu Undivided Family) is ascertained?
4. Explain the relevance of POEM on finding out the residency status of overseas companies.
5. What are the tax implications of income earned or deemed to be earned in India for varied residential status?
6. List down and discuss various kinds of foreign incomes and their taxability in case of RNOR as well as NR.
7. Explain tax incidence to ROR, RNOR and NR with examples.
8. What are the exceptions given in residential status rules for Indian nationals visiting India?

3.8 References

1. Income Tax Act, 1961 – Section 5 and Section
2. Circular No. 6 of 2017 – CBDT guidelines on Place of Effective Management

3. Finance Act, 2020 – Amendments related to deemed residency

4. Income Tax Rules and Notifications – Ministry of Finance

5. ICAI Study Material – Paper 7: Direct Tax Laws

6. Ahuja & Gupta – Systematic Approach to Income Tax

Answers to Knowledge Check

Knowledge Check 1

1. c) 182 days
2. a) Stay in India > 730 days in 7 years
3. c) ROR
4. b) More than ₹15 lakh
5. c) Not liable to tax in any other country

3.9 Case Study

"Residency and Tax Impact – A Case of Arjun Mehra"

Background:

Arjun Mehra, 38, an Indian citizen who is a financial analyst with an investment firm in Singapore. 'So while he has been in Singapore for the past 7 years, During FY 2024-25, Arjun stayed in India for a total of 130 days visiting family members and taking care of some investment properties.

Arjun's income sources include:

• SG$ 15,000 paid per month in salary in Singapore

• Interest ₹2.5 lakh from a savings bank account in India

• ₹3.6 lakhs of rental on a Mumbai flat

• ₹5 lakhs long-term capital gains from the sale of mutual funds in India

• Dividends (USD 2,000) from stocks in the U.S. deposited to his foreign account

Arjun is also a member of an Indian LLP carrying and managing the internet education portal. He is a passive owner who does not manage the operations but he participates in the profit.

Arjun has never filed a return in India, on the premise that he is outside India so cannot be subject to Indian taxation.

Problem Statements

Problem 1: Find the Residential Status of Arjun for AY 2025–26. Solution:

Arjun Section 6(1), Arjun had been residing in India during: -130 days in the current previous year, and more than 365 days during the preceding four years.

As he is on a visit to India, being an Indian citizen the condition of 182 days applies (not just 60 days), if his income in India exceeds ₹15 lakh.

• His total income in India = ₹2.5 lakhs (interest) + ₹3.6 lakhs (rent) + ₹5 lakhs (capital gains)=

₹11.1 lakh

• The 182-day threshold is still there, as it is well short of ₹15 lakh

Arjun spent just 130 days in India. Thus, he falls short of the residency requirement. Answer: FY 2024–

Question 2: State which of Arjun's income will be taxable in India. Solution:

Arjun, being a Non-Resident, is liable to tax only on:

• Income accruing or arising or deemed to accrue or arise in India

• Income received or deemed to be received in India or Having source outside of India situation based: • If the property sold was held for less than 3 years then it shall appear under Short term capital gain and if more than three years it shall reflect under Long term capital gain.

• Interest from Indian bank – Chargeability to Tax This product is e-book.

• Income from Indian property without physical presence – Taxable

• Gains on Indian mutual funds – Taxable • Rental income from overseas properties – taxed at the highest slab applicable to an individual

Not Taxable:

• Singapore income – Foreign wages, non-taxable

• U.S. dividends – Foreign income, exempt under treaty[].

• Share in profit of LLP – Exempt U/s 10(2A) Answer: Total income taxable in India is ₹11.1 lakh

Question 3: Explain Arjun's responsibilities for compliance with Indian tax laws. Solution:

As Arjun's income from India is higher than the basic exemption limit of ₹2.5 lakh, he needs to:

• ITR-2 can use as a Non-resident for filing of income tax return (ITR)

• Remote Indian income under specific heads: Income from House Property, Capital Gains and Other Sources

• Save tax on profit from LLP under section 10(2A)

• Penalty (if any) shall be paid along with interest and tax.

• He does not have to declare income / assets abroad – as a NRI,

The return not filed in time may be subjected to 234F penalty and can be liable for interest under Section 234A/B/C.

Reflective Questions

What will be the difference in Arjun's tax liability if he remains in India for 185 days?

If Arjun was not RNOR, would the foreign dividends be taxable?

How does investment in Indian mutual funds benefit a Non-Resident?

What will be Arjun's tax liability if his Income from Indian Sources exceeds ₹15lakh?

Will the residency of the LLP be affected if Arjun starts the active management of Indian LLP from Singapore?

Conclusion

The case of Arjun Mehra also shows ground level significance of residential status for determining taxability under the Income Tax Act. Though he is a non-resident, Dalal's financial interests in India makes the tax compliance mandatory. Residency does not depend entirely on a person's nationality, but partly on his physical presence, authority, or income. The depths of section 5 and 6 are crucial for global Indian citizens if they want to ensure that their compliance is correct, planning meticulous and would save penalties senselessly.

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Unit 4 Income from Salary

Learning Objectives

1. Define the concept of salary income and differentiate it from other sources of income under the Income Tax Act.
2. Identify various components of salary, including basic pay, allowances, perquisites, and bonuses.
3. Classify different types of allowances (taxable, partially taxable, and fully exempt) and understand their tax implications.
4. Explain the concept of perquisites, including their valuation and tax treatment under the Income Tax Act.
5. Compute gross salary income by aggregating all salary components and adjusting for exempt allowances.
6. Apply relevant deductions under Section 16, including standard deduction, entertainment allowance, and professional tax.

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4.0 Introductory Caselet

"Spin and Solve Mr. Arjun's Salary Puzzle: Gross Pay & Taxable Income explained clearly"

Mr. Arjun Verma (38) is Senior Sales Manager with well-known FMCG company and based in Mumbai. He has been serving with the organization from last 8 years and also he gets good salary combined with lots of other things. As the financial year closes, Mr Arjun wants to know how much of his salary is taxable in truth and if he can avail exemptions and deductions allowed under the Income Tax Act.

And here is the overview of his monthly earning for your convenience:

Salary Component Monthly Amount (₹)

Basic Salary 60,000

House Rent Allowance (HRA) 25,000

Transport Allowance 2,000

Special Allowance 13,000

Mobile Reimbursement 2,500

Employer's Contribution to PF 7,200

Additional Annual Benefits:

• Annual Bonus: ₹1,20,000

• Gift Voucher (On Diwali): ₹6,000

• Company lease car provided for business and personal use

• Mr. Arjun's rent: ₹22,000 a month for a rented apartment in Mumbai (Mr. Arjun also claims the deduction under Section 16 of the I-T Act.) These include:

• Standard Deduction

• Professional Tax (Employer will deduct)

• Other appropriate deductions, if any

Mr. Arjun has consulted a tax expert to clear his doubts, as under:

• What amounts to gross salary in his case?

• What part of his salary is fully taxed, partially exempt or fully exempt?

• What is the perquisite for HRA?

• How are benefits like the gift voucher and company-leased car taxed?

• What is his total taxable income from salary after deductions?

This case is intended to help students relate the tax concepts to a practical salary structure, calculate step by step and understand the legal provisions governing exemptions and perquisites.

Critical Thinking Question:

Considering the current salary structure of Mr. Arjun, what legal and financial moves he can make during the coming financial year to maximise his taxable salary income? How should he plan his salary components with his employer for maximum tax efficiency while still being completely compliant under the Income Tax Act?

4.1 Meaning and Features of Salary

4.1.1 Definition of Salary under the Income Tax Act [Section 17(1)]

The expression "salary" is also defined in s. 17(1) of the Income-tax Act, 1961 taking an inclusive definition. Such specifying the apart from what is generally accepted as salary, it specifically includes many other kinds such payments in cash and kind.

6.Under Section 17(1), the term ‘salary’ was explained to mean any payment received by an employee for rendering services to his employer.

Wages

Annuity or pension

Gratuity

Fees, commissions, perquisites or profits in lieu of salary.

Advance salary

Leave encashment

Employer’s contribution in an RPF over the statutorily prescribed limit

Balance shifted from an Unrecognized Providend Fund to a Recognized Provide... 6.55 4) Balance transferred from other Provident Fund Accounts* -

– Investment in pension plan such as NPS (National Pension Scheme) under Section 80CCD

The broad interpretation of that definition makes sure no part of a payment by an employer slips through the tax net just because it can't be labelled "salary" in familiar or small letter usage.

Key points to understand:

• Perquisites and allowances are 'part of' salary (even if paid in kind, e.g., accommodation, company car or medical support).

• Income in the nature of profits in lieu salary (e.g., compensation due to early termination of employment, retirement benefits not received as gratuity) is also taxed as 'salaries'.

• Commuted and uncommuted pension: How tax is paid on the pension will depend upon whether it's received in a lump sum or over a period.

• Jurisprudence: The case law is clear that the word “salary” in clause 17(1) should be given a broad interpretation such as to encompass all forms of remuneration, directly or indirectly related to employment.

And so the legal definition of 'salary' guarantees that income derived from employment is fully taxed and cannot spring a leak as an alternative source of remuneration.

4.1.2 Relationship: Employer and Employee (vs. Contractor)

The situation of an employer- employee relationship is one of the most vital condition to levy tax on the income under the head “Salaries”. Salary head It is important to note that all remuneration are not taxed under Income Tax Act as salary It makes distinction between any payment by an employer to a employee. Even in respect of such payments under a contract for services (a consultant or contractor), the tax will be applicable under “Profits and Gains from Business or Profession” and not “Income from Other Sources.” These are certainly not covered under the head “Salaries”.

Characteristics of Employer-Employee Relationship:

• Control and Supervision: The employer has control not only over what is to be done but also the manner in which it should be done.

• Contract of Service and Contract for Service: Those employed are under a contract of service (master-servant relationship) while who render their services have contracted to provide them. The self-employed sell a contract of service.

• Mode of Payment – While, employees are generally paid a fixed PAY OUT monthly (salary), the payment for contractors is usually on specific projects or tasks.

• Benefits and Perks: An employee may enjoy perks like provident fund contributions, leave benefits, health insurance and retirement benefits (not available to independent contractors).

Legal Tests to Determine Relationship:

Control Test: Who has the right to control how work is done?

Integration Test Is the task an integral part of the business?

Test of Economic Control: Who is at risk for profit or loss?

Tax Implications:

• If the person rendering service is an employee, remuneration received by him for his services are taxable under the head “Salaries” and it is the employer who will be responsible to deduct tax at source (TDS) under section 192.

• If the individual is a contractor, tax is withheld under Section 194C and income is taxed as professional or business income.

Proper classification is important to ensure appropriate tax withholding and compliance with employment laws.

4.1.3 Basis of Charge: Due or Receipt, Whichever is Earlier

The Income Tax Act provides for the chargeability of salary income under Section 15, that is it is taxable on.

“due or receipt” as the case may be, whichever is earlier. Meaning of "Due":

Salary is said to be when it is legally payable,regardless as to whether it has actually been paid. For example, the wages for March are due on 31 March of any year, whether or not they have been paid yet.

Meaning of "Receipt":

Wages are payable to the employee when they are put into the employee's possession or Scribbled out of them in cash, order, cheek or direct deposit.

Application of the Rule:

If wages are earned but not received, they are considered as taxable income in the year that it becomes due.

Advance Salary is Taxable In The Year Of Receipt If salary is received in advance, though not due, it will be taxable in the year of receipt.

Where salary becomes due and is actually received in the same year it is taxed in that year.

If the arrears of salary in question have been received, they should be taxed in the year in which these are received after providing relief u/s 89(1).

Examples:

•When an employee is paid March salary in the month of April (arrears), it may be taxed in April.

• In such cases where arrears for past years are received in the current year, entire amount will be taxable in year of receipt but relief under Section 89(1) may be claimed to reduce incidence of tax.

This rules of thumb make certain that wherever savor is received, compensation is definitely taxed and early attention isn't deferred. It also synchronizes taxability with accounting and cash flow concerns.

4.1.4 Components of Salary: Basic, Bonus, Commission, etc.

Salary doesn't confine to the lowest pay of your employees. It is a mix of parts, each with its own tax implications. It is of importance to comprehend all of this for the purpose of a correct determination of income subject to tax.

Major Components of Salary:

Base Salary: The base of the salary. The gross salary is fully taxable and also acts as a foundation on which other elements are calculated such as HRA, PF, gratuity etc.

Dearness Allowance (DA) DA is an allowance that is paid to compensate for the cost of living of an employee, and it is completely taxable. The portion of the salary may be used, in part, to calculate retirement benefits.

House rent allowance (HRA) HRA is partially exempt under 10(13A) if the employee lives in rented premises and pays rent. The exemption is calculated using a formula that takes into account salary, rent paid and city of residence.

Commission (if based on a % of turnover achieved) is taxable. If the food is considered a part of the salary, it could also impact calculations in respect of HRA and retirement benefits.

Bonus and Incentives: Paid as reward for performance These amounts are fully taxable in the year of receipt.

Overtime Pay: When you work extra hours, your employer pays you more money, which is added to the total sum of your pay and taxed.

Allowances:

o T/ Allowance-: Exemption of T.A up to a limit only for handicapped employee.

o Education Allowance: Partially exempt for a maximum of two children.

o Medical Allowance: fully taxable if received as fixed amount; however, the reimbursements can be exempted up to a specified limit.

Perquisites:

o Free rent on accommodation, use of company car, discounted loans etc.

o Prescribed norms are followed for valuation and its taxed.

Retirement Benefits:

o Provident Fund : Employers contribution up to 12% of salary is tax exempt; Remaining is taxable.

o Gratuity: If received at the time of retirement, Taxable/Exempt as per nature of employment and Quitting during Continuance Upon Employee amount respectively.

o Leave Encashment: To some extent exempt on retirement; completely taxable while being in service.

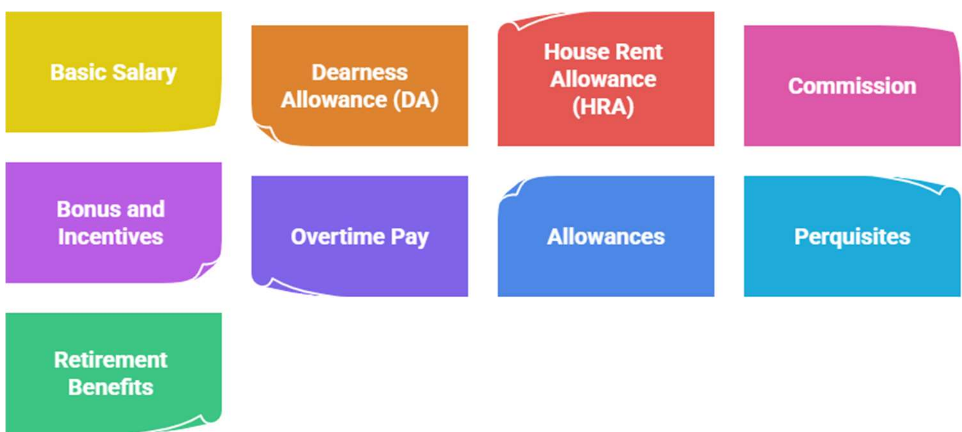

Figure 4.1

Additional Points:

- Advance salary and arrears are taxed in the year of receipt but may qualify for relief under Section 89(1).
- In-kind benefits such as stock options or club memberships are taxable as per their fair market value.

Did You Know?

“In addition to cash payments, even non-cash benefits like rent-free accommodation, concessional loans, or use of a company vehicle are considered part of salary and taxed as perquisite under the Income Tax Act.”

4.1.5 Advance Salary, Arrears, and Treatment under Tax

As per Income Tax Act, the salary income is taxable on due or receipt basis whichever is earlier. This provision of law has great bearing on advance salary and arrears of salary. 45: Schedule of payment under the head "Income from Salaries''Both are distinguished in terms of timing, but both ultimately suffer tax under the head "Income from Salaries.''

Advance Salary

Advance salary is a portion of salary paid in advance to the employees before it becomes due. So, for example if an employee receives salary for the month of April on 28th March, then it would be treated as advance salary.

• Taxability: An advance or salary is taxable in the year of payment and not in the year to which it relates.

•TDS Responsibility: The employer is also bound to deduct tax at the source (TDS) for the month in which the salary has been paid including advance payments.

• No Double Taxation: Subsequent taxation does not occur when salary is paid in later year because it has already been taxed in the preceding year

• Relief Hos not admissible: In case the benefit of relief has already been claimed in any subsequent previous year, benefits of Section 89(1) shall cease to be admissible after assessment years 1998-99. Despite this unfavourable treatment by the tax law – relief is available u/s 89 and comes within the powers of Tribunal while considering whether assessee declares income wrongfully.

Arrears of Salary

Arrears include salary received in the current year which relates to a previous year and are paid due to delayed payments, revised pay or arrears. For instance if an increase in salary from 01 Jul 2022 is made payable from June 2023 then the extra paid for the month of July is referred to as Arrears.

• Taxability: Arrears are taxable in the year they are received, but relate to previous years.

• Effect on TDS: The employer needs to consider the arrears for computing the total salary paid in the year and make deduction of TDS on it.

• Relief under Section 89(1): Arrears can artificially inflate the taxable income in the year of receipt, which may result in higher tax liability and employee can claim relief u/s 89(1) to ease this burden.

Relief under Section 89(1)

The relief provision in Section 89 (1) is designed not to penalize the taxpayer on account of timing difference regarding when the salary amount is paid. The relief is the lesser of the tax payable:

On full amount with arrears/advance received during the year.

Net of the tax which would have been payable if arrears /advance was received in earlier year(s).

So much of the variance is considered as relief, if any. The process is explained in Rule 21A of the Income Tax Rules and Form 10E has to be filed online for claiming this deduction.

Illustrative Differences

Type Taxed In Year of Relief Available

Advance Salary Receipt Yes

Arrears of Salary Receipt Yes

Other Related Points

• Voluntary Retirement Compensation: If received in installments, each installment is taxed in the year of receipt.

• Retrospection in Promotion: The reverse of arrears; Salary increase made effective at a prior date.

• Settlement on Resignation/Dismissal: Lump sum payment received for service not rendered is taxable in the year of receipt.

Knowing the rules for advances and arrears allow proper differentiation of income, elimination of unnecessary tax burden. It also underscores the role of financial planning and the relief provisions to help achieve equity in taxation.

4.2 Allowances

With respect to income from salaries, allowances are certain fixed amounts paid by an employer to the employee for the purpose of meeting some particular type of expenditure. These may or may not be taxable, depending on the nature, use and provisions of the Income Tax Act. This is because pay in a general sense is compensation for services, whereas an allowance can give a worker extra payment to cover work or non-work related expenses such as accommodation, transportation, uniform, education or cost of living.

Allowances are major ‘chunk‘ of the compensation structure and vary depending on Job Profile, Company Policy and Statutory norms. Such allowances are taxable in full or in part,

as the case may be. It is important to know the classification and tax treatment of these allowances for calculation of income as well as planning your taxes.

4.2.1 Definition and Classification of Allowances Definition:

Allowances are predetermined fixed amounts paid by the employer to employee for incurring expenses on some specific needs. These are generally paid on monthly basis with the salary and can be fully taxable, partly exempt (Section 10) or fully exempt (under section 10(13A)) as per Income Tax Act.

Income Tax Act does not define “allowance” However, their tax characterization is founded upon

You may refer Section 10(14) and Rule 2BB of the Income tax Rules.

Classification of Allowances:

Allowances can be broadly categorized into three based on their tax treatment:

Fully Taxable Allowances:

These are complete allowances which shall be added to gross income of an employee and tax free up to the slab amount. There are no exemptions or deductibility provisions of any kind.

Examples:

• Dearness Allowance (DA)

• Overtime Allowance

• City Compensatory Allowance

• Servant Allowance

• Warden/Proctor Allowance

• Lunch or Tiffin Allowance

Partially Exempt Allowances:

These deductions, based on particular terms, restrictions and or costs are partially tax-deductible. The remaining amount, if any, is taxable as salary income.

Examples:

• House Rent Allowance (HRA)

• Transport Allowance (provided to personnel with disability restricted to certain community only)

• Children's Education Allowance

• Hostel Expenditure Allowance

Exemption is normally under Section 10(14) and is controlled by Rule 2BB.

Fully Exempt Allowances:

These are benefits taxed, but only to the extent it is not exempt under certain circumstances. These are typically applicable to employees working under certain conditions, for example, government employees stationed abroad or those working in isolated or dangerous places.

Examples:

• Foreign Allowance to government employees

• Allowances received by UNO employees

• Estimate of Allowances for High Court and Supreme Court Judges

• Sumptuary Allowances drawn by High Courts and Supreme Court judges

Every category has it's own tax implication and should be reported properly in the IT return. Misreporting could cause under reporting of income and potentially penalties under the tax code.

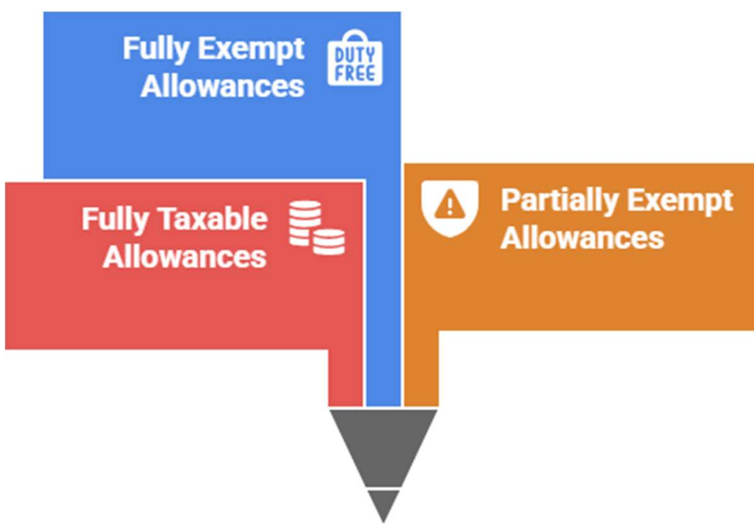

Figure 4.2

4.2.2 Fully Taxable Allowances (e.g., Dearness Allowance)

Fully taxable allowances are those which forms part of the taxable salary income of an employee and there is no exemption from tax in terms of Income Tax Act. In case of Assesse, following articles have become a part of gross salary and are subject to tax on the basis on the slab rates.

Examples of Fully Taxable Allowances:

Dearness Allowance (DA):

o DA is remuneration to staff to cover the inflationary effect on cost of living. It is commonly in terms of percentage of basic salary.

o DA is taxable in full, under the head "Income from Salaries".

o If the terms and conditions of employment stipulate the inclusion of DA in salary for retirement benefits (PF – gratuity, etc.), then it shall be included while calculating retirement benefits.

City Compensatory Allowance (CCA):

o CCA is given to employees to compensate for high cost of living in urban / Metros.

o Although it is a compensatory grant, the same is in the nature of taxable salary income in the hands of employee.

Overtime Allowance:

o Payment for overtime worked outside the hours of employment in general.

oTreated as taxable income for allowances, regardless of the level and frequency.

Servant Allowance:

o Provided to staff for domestic aid.

o Full amount is subject to tax, regardless if funded as used for the intended purpose.

Tiffin, Lunch or Meal Allowance:

o Any flat-rate deduction-for-meal or snacks paid is chargeable to tax fully.

o Free meals up to ₹50 per meal at office premises may not be taxable under the perquisite rules though.

Warden/Proctor Allowance:

o Paid to teachers or employees performing residential duties in hostels, schools & academies.

o Fully taxable.

Non-Practicing Allowance (NPA):

o Paid to government or public sector employed doctors who are prohibited from private practice.

o Taxable in full as salary.

Points to Note:

• These free medical allowances are included in gross salary and taxed at their appropriate slab rates without allowing any deductions or exemptions.

• These need to be included in Form 16 and TDS be deducted as per section 192.

• Employees are not entitled to any common or special reductions on these allowances until otherwise informed.

Clear clarity about fully taxable allowances is the need of an hour which is even important for accurate gross salary computation and while estimating exemption claims immediately if it got high then notices/disallowance shall be followed.

4.2.3 Partially Exempt Allowances (e.g., HRA, Transport Allowance)

Partial Exempt Allowances: Partial exempt allowances are the allowances, which are fully or partly exempt up to a maximum limit or exceptions. An amount in excess of capped limit is fully added to the taxable salary income. These allowances are regulated by Section 10(14) of the Income Tax Act and explained in the Rule 2BB of the Income Tax Rules.

Major Partially Exempt Allowances for Example :

House Rent Allowance (HRA):

o Paid to employees residing in rented houses.

o Exempt under Section 10(13A).

o The exception amount is the lowest of the follow:

♣ Actual HRA received

♣ Rent paid less 10% of the salary

♣ 50% of basic (in metro cities) or 40 % (for non-metro areas)

o If the employee resides in a house owned by him or does not pay rent, then the entire amount received as HRA is taxable.

Transport Allowance:

o Subject to the provisions of work only for a person with certain physical disability (Blind, orthopaedically disabled etc) Employers required curriculums are?

o ₹3,200 p.m. exemption is given to these employees.

o For the balance, there is no tax on transport allowance after amendments of 2018.

Children's Education Allowance:

o Exemption of ₹100 per child per month upto 2 children.

o Total exemption ₹ 2,400/- per annum.

Hostel Expenditure Allowance:

o Exempt if contributions were not exceeding ₹300 per month per child for two children.

o Entire exemption of ₹7,200 per annum.

Special Compensatory (Hill Area) Allowance:

o Relaxation to the extent as provided under Rule 2BB.

o Rates depend on area and can be between ₹300 and ₹7000 per month.

Tribal Area Allowance:

o Permitted up to ₹200 per month for employees working in scheduled tribal areas.

Underground Allowance:

o Paid to workers who work in subterranean mines.

o Exemption to the extent of Rs. 800 per month.

Important Points:

• If you do claim the exemptions, you have to pay tax on any amount over this.

• These exemption are not automatic and appropriate evidences like rent receipt (in case of HRA), evidence for school fees or medical certificate (in case of transport allowance) must be kept in place while claiming these.

• Salaried individuals who want to claim the standard deduction will need to ensure that their employer puts up right amount of exempt in Form 16, hence there is no mismatch in income tax return.

These deductions provide potential for tax savings, but require the appropriate documentation and meeting of exemption guidelines.

4.2.4 Fully Exempt Allowances (e.g., Foreign Allowances for Government Employees)

Fully exempt allowances are not considered for the purpose of computing the gross total income if certain conditions are satisfied. They are typically given to employees under extraordinary circumstances, including postings overseas, working in establishments (like the United Nations), and difficult terrains such as border territories, tribal areas, etc.

The exemptions are under Section 10(14) read with Rule 2BB of the Income Tax Rules and certain other specific provisions of the Act. The reason for such exemptions is to provide incentives for serving in stressful locations or consider overseas postings that bring forex earnings or showcase India.

Examples of Fully Exempt Allowances:

Foreign Allowance [Section 10(7)]:

o Foreign Service Upc Indian citizens who are government employees are posted at embodiment (applicability) : abroad on duty / service Foreign Services 3.

o The global allowance received during the assignment is completely free of tax.

o This exclusion is in recognition of the unique nature of foreign assignments, where employees reside in high cost environment and are de facto representatives of Indian state.

o The relief is available only to commissioned employees of the government (state and center). Private foreign-employed workers are not exempt from paying tax, and should be taxed on their earnings.

Allowance to UNO Employees:

o Staffers working with the UNO are entirely excluded from taxes in India on any allowance or salary received by him/her from the United Nations Organisation.

o This is on account of international treaty obligations, which is incorporated into the domestic law in Section 2(24) and its explanations.

o Indian citizen working as employee of the UNO or its Specialized Agencies like WHO, UNESCO, etc., are to be taxed in India without insisting that he should get any exception under Section 10(14).

Salaries and Allowances of the Judges of High Court and Supreme Court:

o By reason of certain rules (like Rules 10(17A) in the case of Judges of High Courts and Supreme Court or other Judicial Service Rules, etc.), allowances to a Judge are relieved from tax entirely.

o This even includes sumptuary provisions, which are there for the cost of official hospitality.

Compensatory Allowances under Section 10(14)(i):

o Some compensatory allowances received for employment in certain difficult or hazardous conditions are fully exempt as specified.

o Examples include:

♣ High-altitude allowance

♣ Field area allowance

♣ Border area allowance

♣ Counter-insurgency allowance

o These paid for the armed forces/paramilitary personnel are exempt in full, if they do not exceed limits prescribed by the government.

Allowances to MPs and MLAs [Sections 10(17)]:

o MPs and MLAs get different types of allowances - Daily Allowance, Constituency Allowances, Office allowance etc.

o These are also covered in Section 10(17) to the extent they do not represent salary.

o The exclusion safeguards the autonomy and effectiveness of Members of Parliament o The exemption promotes and maintains the independence of elected representatives.

Important Considerations:

• Only those allowances notified by Central Board of Direct Taxes (CBDT) as fully exempt or covered by statutory provisions are to be considered fully exempt.

• Employers often have to attest that the allowance is provided under eligible circumstances.

• Taxpayers must check if such allowances have been correctly disclosed in Form 16 and ITR despite being exempt.

• Misclaims under "fully exempt" categories could draw penalties or disallowances during scrutiny.

These allowances fully exempt are based on the rationale that remuneration for services rendered in the national interest, or in pursuance of a diplomatic or international assignment outside India, should not be taxed so as to encourage Indian Professionals to accept such assignments.

4.2.5 Tax Planning and Documentation for Claiming Exemptions

Exempting allowances is not a given, one has to plan for it, classify and document correctly. Though the Income Tax Act provides various exemptions under Section 10(14) and other

provisions, yet the obligation remains on the taxpayer to substantiate the exemption claimed through documentary evidence so that it is in accordance with law.

Good tax planning with regards to Allowances includes the structuring of one's salary in such a way that you receive as much exempt income as possible without breaking any laws. This is particularly so for salaried persons whose options are less as compared to business men.

Fundamentals of Tax Planning with Allowances:

Understanding Eligibility:

o Not every employee has eligibility under all exceptions.

o For instance, HRA benefit cannot be availed if an employee stays in his own house or with family and no rent is paid.

o Disabled employees have been allowed exemption of transport allowance under specified circumstances only.

Optimizing Salary Structure:

o The salary package can be mutual created by the employer and employee, which should include more tax efficient allowances.

o Partially exempt allowances such HRA, children education and hostel expenditure allowance may form part of the salary structure that can lower down the taxable salary.

o Taxable allowances are some things, which cannot be avoided (i.e.City compensatory allowance etc), but at the same time we can try to keep them as low as possible.

Avoiding Misclassification:

o Any misreporting of fully taxable/allowances as exempt would be communication barrier.

o For example-meal allowance given in cash is fully taxable, free meals provided at office upto certain limit are exempted under perquisite rules.

Claiming Exemptions Only When Applicable:

o Exemptions from Rule 2BB are partial and specified. Exceeding the threshold of exemption will put your income back in list of taxable amount.

TDS Planning:

o All exemptions and supporting documents should be disclosed by the employees to their employer at the beginning of fiscal year, so that TDS computation could be done in a proper manner.

o If exemptions are not declared TDS may be deducted on higher side and refund has to be Claims at the time of filing returns.

Figure 4.3

Essential Documentation for Allowance Exemptions:

House Rent Allowance (HRA):

o Rent receipts with the name of landlord and a valid PAN (If the paid rent is more than ₹1,00,000 per year)

o Rent agreement (optional but recommended)

o Payment evidence: e.g. bank transfer sheet

Children’s Education and Hostel Allowance:

o School fee receipts

o Receipts of hostel fees mentioning charges of boarding/lodging

Transport Allowance for Disabled Employees:

o Certificate from competent medical authority/State Disability Commissioner ii.

o Copy of employment under eligible category

Allowances for duty in Remote Area or Field:

o Employer's certificate mentioning the detail of occupation & area of posting

o Government notifications supporting eligibility

Section 89(1) Relief for Arrears or Advance:

o Form 10E submission

o Employer’s proforma sheets of increase and decrease in arrear basis or advance calculation

Common Mistakes to Avoid:

- Claiming HRA without actually paying rent/belief of not living in own house
- Submitting same rent receipts without proof of payment
- Considering fully taxable allowances as exempt

Failing to declare exempt income in the ITR (even if it’s tax-free, it has to be reported)

- Failure to produce receipts of children education/hostel service charges.

It is good business to plan for tax allowances so taxpayers can receive the most of their legitimate exemptions and be in compliance with statutory mandates. It also minimizes exposure to tax notices, assessments and penalties. 4d) Employees should work with HR or tax advisors to apply their wage in the best possible way (tax-wise), which means proper documentation and reporting in time.

4.3 Perquisites

Perquisites are an important part of the salary and are therefore also very crucial in the tax framework provided by the Income Tax Act. They are terms referring to general compensation in some form or another, not necessarily a specific item of equal (monetary) value. Either could be on cash basis or in kind addition and would become taxable as salary under the provisions of Section 17(2) read with section 15 to be found under Income Tax Act. The logic behind taxing perquisites is to eliminate possibilities of tax evasion by making non-monetary benefits instead of cash salary. Knowledge of the tax treatment of perquisites is important for proper determination of income and planning effective taxation.

4.3.1 Definition and Nature of Perquisites [Section 17(2)]

Section 17(2) of the Income Tax Act, 1961 defines „perquisite? in an inclusive manner. It defines perquisites as benefits or facilities provided by the employer to/for an employee in cash, kind or any form other than salary. This term is construed broadly so as to encompass all non-cash and indirect benefits which make up the overall remuneration.

Perquisite has been defined under Section 17(2) to include the following:

The amount of free lodging given the employee.

The consideration of any concession in respect of rent allowed by the employer for such accommodation.

471(5) "perquisite" means any benefit or amenity granted free of cost or at concessional rate to specified employees.

An amount paid by the employer in connection with an obligation which was actually that of the employee.

The amount paid by the employer for life insurance or on an annuity contract, if it is a benefit to the employee.

The value of any specified security or sweat equity share allotted to the employee free of cost or at concessional rate.

Exceeds the prescribed limits, of employer's contribution to recognised provident fund or superannuation fund and such other fundsi N.P.S.

Interest free or concessional loans provided by employer to employee.

Any other fringe benefit or amenity as may be provided under the Income Tax Rules.

Some of the salient features of perquisites are :

• Perks can be either cash or non-cash, however if it is to the personal benefit of employee and earned directly out of employment, then such perks are taxable.

• The employer has to provide the perquisites; it doesn't include benefits provided by third parties.

• The valuation of perks shall be as per Rule 3 of the Income Tax Rules.

The tax burden on perquisites is on the employee but limited only to certain employees called as "specified employee" (usually any director or an employee drawing salary more than ₹50,000). It is very important to have accurate valuation and classification for the purpose of making sure you are compliant, and avoid tax disputes.

4.3.2 Taxable Perquisites (e.g., Rent-Free Accommodation)

Taxable perquisites are the fringe benefits which would be taken into account in computing the income under salary of an employee. These emoluments augment the money value of his salary or diminish his own spending. The Income Tax Act prescribes that some perquisites are always taxable, while others are chargeable only in the hands of certain categories of employees.

Key Examples of Taxable Perquisites:

Rent-Free Accommodation (RFA):

o The most encountered taxable perquisite.

o Where house is provided by the employer to the employee on rent free basis, its value shall be taxable in hands of employee as per Rule 3.

o The valuation is determined by whether the employer rents or has housing, and the size of the city.

o For government employee value of perquisite will be license fee as notified by the govt.

Concessional Accommodation:

o If employee is paying rent less than fair rental value, the shortfall will be taxable as perquisite.

Use of Employer's Automobile for Personal Needs:

o If the company supplies a motor car and pays for official and personal use, then a lump sum perquisite is added to salary according to the size of the engine.

o If the vehicle is only for private use—an element that's very difficult to determine—the employer charges tax on the full cost incurred.

Education for Free or at a Concessional Rate for Children:

o If the employer runs an education institution, then the value of perquisite is worked out on similar lines of cost if a child was to be educated in institute at discounted cost.

o Exempt up to ₹1,000 a month per child.

Interest-Free or Concessional Loans:

o If at a rate less than the prescribed rate loans are provided by the employer, the interest differential

is taxable as a perquisite.

o However, no deduction is available if the total loan doesn't exceed ₹20,000.

Employer to Pay the Income Tax:

o An employer who pays the employee's income tax is viewed as providing a taxable perquisite.

Club Memberships and Holiday Expenses:

o If the employer pays club fees or travel costs that are unrelated to official duties these would be treated as a taxable benefit — See 2(3) above.

Gifts and Vouchers:

o Gifts in excess of ₹5,000 per annum is taxable.

ESOPs and Sweat Equity Shares:

o Allocated on concessional or free of charge basis – between FMV and Ex Price

is taxable.

*“Fringe benefit perquisites” is an extremely crucial aspect for TDS as the same needs to be calculated & declared correctly in Form 16. Misreporting or failure to report will lead to fine or increased tax liability.

4.3.3 Exempt Perquisites (e.g., Medical Reimbursement up to limits)

Although most of the perks are taxable, the Income Tax Act prescribes certain perquisites which are either fully or partially exempt from tax. These benefits would be either non-cash perks for welfare or cash dispensations outlaid by the employee in course of employment.

Key Exempt Perquisites:

Medical Reimbursement (up to AY 2019-20):

o In cases where no medical reimbursement was paid by the employer: Till AY 2018-19, up to ₹15,000 p.a. (along with travel and transportation) was exempt for medical expenses.

o With effect from FW 2018, this exemption has been removed after introduction of standard deduction in Budget 2018.

o But medical service in employer-hospital or through tie up hospitals will continue to be exempt.

Medical Insurance Premium:

o Premium paid by an employer under group health insurance policy is not considered as a perquisite.

o If treatment taken in government or approved hospitals, it is exempt completely .

1SOW NOT/Plan for Laptop s/Desktops/Mobile Phone:

o The same shall not be treated as a perquisite.

o Mobile phones and laptops, even if these are for personal use, are usually not subject to tax.

Refreshments in Office Premises:

o The small tea, coffee and refreshments provided in office hours are not to be treated as a perquisite.

Employer's Contribution to Approved PF (upto 12% of salary) 0.00:

o Contributions below the statutory threshold are excluded.

o If contributions exceed the limit, they are subject to taxation.

Repayment of Expenses Incurred on Official Business:

o Any travel, transportation or per diem paid to employees in connection with tours of duty/field duty is not taxable if properly documented.

Government employees overseas: Perquisites to be furnished.

o Some allowances and perks paid to the government servants working beyond India are free under section 10(7).

Use of Uniform:

o The value of uniforms supplied by the employer is not subject to excise tax if wearing of the uniform is required.

Cabins and UNO Officers:

o Judicial and international staffs are kept outside the purview under the respective sections for perquisites provided at such position.

Such exemptions incentives the employees and employers for providing non-cash welfare benefits but simultaneously reduce tax incidence on the employees. But the exemptions are heavily conditional, capped and you need to keep evidence of everything you've tried.

4.3.4 Valuation Rules under Income Tax Rules

The value of perquisites is determined under Rule 3 of the Income-tax Rules, 1962. These regulations provide details on how to calculate the amount of benefits given by an employer to an employee. It is important so as to calculate the taxable salary and also to ensure that the employer deducts appropriate TDS.

Principal Valuation Standards pursuant to Rule 3:

Rent-Free Accommodation:

o Public servants: Government-set license fees will be the value for tax.

o Non-government employees:

♣ If made available by employer: Value is taxed on a percent basis (7.5%, 10% or 15%) times salary of the city population.

♣ In case of such accommodation provided by employers: If hired, minimum of actual rent paid or 15% of salary is the value to be taxed.

o Salary will include Basic, DA (if considered for retirement), bonus, commission and all other taxable allowances.

Motor Car Provided by Employer:

o For official use only: Tax not included, provided supporting documentation exists.

o Private or mixed-use (Business and private):

♣ Fixed amounts (₹1,800 or ₹2,400 per month along with chauffeur charges) for engine capacity are also stated.

♣ If only personal use: The amount paid by the employer to provide the benefit is taxable.

Interest-Free or Concessional Loans:

o Tax shall be levied on the difference of interest actually charged and SBI rate.

o Loan below ₹20,000 is exempt.

Educational Facility:

o If in employer-owned institution: the value is cost in like institutions.

o At-least exempt ₹1,000 per child per month.

Sweat Equity and ESOPs:

o Taxed on the spread between FMV at date of exercise and the exercise price.

o FMV is determined by merchant banker in case of unlisted shares.

Gift Items:

o Where gifts of Rs.5,000/- or more in the aggregate are received annually by an assessee by any mode from any person(s), it is chargeable to tax as income.

Club Memberships, Holiday Expenses, etc.:

o Full cost is taxable if not used entirely for official purposes.

Valuation under Rule 3 will have to be done on a monthly basis for TDS. Mistakes in valuation could potentially result, not just in under-reporting of income but also in penal implications for both employee and employer.

4.3.5 Reporting and TDS By The Employer

The employer has a statutory obligation to withhold tax at source (TDS) on the salary disbursed, which shall include taxable perquisites. The Income Tax Act prescribes a specific responsibility under Section 192, for correct calculation, evaluation and declaration of salary income along with all the benefits available thereon.

Key Employer Obligations:

TDS on Perquisites:

o The TDS on the salary should be deducted on Gross amount of Salary i.e. 'Salary+ Value of perquisites'.

o Evaluations shall conform to Rule 3.

o Perquisite value should be added in Form 16 and Form 12BA by the employers.

Reporting in Form 16:

o The perquisites breakup should be reflected in Part B of Form 16.

o Form 12BAcomes with an annexure showing the item-wise value of perquisites and benefits that has been provided.

Disclosure of Non-Monetary Perquisites:

o If there are in kind perks /benefits being given (like rent free accommodation) TDS still has to be deducted on the monetary/remuneration income.

Timely Valuation and Calculation:

o Perquisite values should be calculated on monthly basis for TDS adjustments by employers.

o All one-time benefit (say, ESOPs extended apart from salary) should be booked in the month of allotment/exercise.

Collection of Declarations:

o Evidence must be collected by employers for the exempted fringe benefits (For example: Medical bills, rent receipts).

o Appropriate record-keeping is required to support exemption or taxation.

Penalties for Non-Compliance:

o Non-deduction / non-payment of TDS on perquisites can also lead to interest u/s 201, penalties under section 271C and disallowance of expenditure.

Employers should work closely with human resource and finance departments to ensure compliant practices. Tax professionals, as well as payroll software, need to be updated with latest regulations so that no errors can creep into TDS and reporting.

"Activity: Classify the Perk"

Students will be divided into small groups and given a list of 15 perquisites, such as rent-free accommodation, medical insurance, club membership, concessional loans, gift vouchers, and ESOPs. Each group must classify these into taxable, partially exempt, or fully exempt, citing

the relevant section and valuation rule. They will then present their reasoning, supported by legal provisions. This activity encourages application-based learning and reinforces the interpretation of Rule 3 and Section 17(2) in real-world scenarios.

4.4 Deductions from Salary

Under the heading "Income from Salaries", you can claim certain deductions from your gross salary income, which will give you net taxable salary. These deductions are contained in the Section 16 of the Income Tax Act, 1961 and also regards relief provisions under Section 89 for arrears or advance salary. These deductions are in addition to the standard Chapter VI-A deductions (like 80C, 80D etc), and can only be availed by salaried taxpayers.

4.4.1 Standard Deduction [Section 16(ia)]

The standard deduction is a uniformed deduction from gross salary for expenses which are necessarily incurred in the pursuit of employment, for example: transport to and from place of business, self-sustenance or other work-related employment costs. It takes the place of transport allowance and medical reimbursement that were available under the old regime but was withdrawn by Budget 2018.

Key Features:

- Standard deduction is ₹50,000 per year now.
- It is open to all salaried and pensioned personnel.
- Regardless of actual expenses, can be taken- you do not have to prove or submit receipts.
- The deduction is allowed when part of the year is served or a salary paid for a few months.

Legislative Background:

- Inserted under Section 16(ia) by the Finance Act, 2018.
- Originally at ₹40,000 and subsequently raised to ₹50,000 under Finance Act 2019.
- Intended to make it easier to comply with the tax code by eliminating various exemptions in favor of a single, larger deduction.

Application:

- Allowed once a year, not pro-rated for the months.
- TDS dedcution is by default for employers.
- It also applies to pensioners by treating pension as salary income.

Standard deduction has been a unifying factor to provide tax relief for all without any evidences or proof.

4.4.2 Entertainment Allowance [Section 16(ii)]

Entertainment Allowance is a part of the Salary paid by Employers to employees to meet hospitality expenses, etc. выполнить оффициальные обязанности. It is completely taxable for private-sector employees, and under Section 16(ii), deduction is available only for government employees.

Deduction for Government Employees:

• The rebate under Section 16(ii) is available to only government employees (central or state).

• Deduction is the smaller of:

Actual entertainment allowance received

20% of basic salary

₹5,000

Key Points:

• The word “salary” for the purpose of this calculation does not include dearness allowance, other allowances or perquisites.

• Private Sector employees not permitted deduction even where entertainment allowance is included in CTC.

•Gross salary is increased by entertainment allowance: There will be a separate claim made in respect of the deduction under Section 16(ii) from the amount o0f entertainment allowance.

Illustration:

For example, if a government employee gets a basic salary of ₹25,000 per month and is paid entertainment allowance of ₹1,500 per month then the amount deductible under section 16(ii) will be least of;

• Actual EA: ₹18,000

• 20% of basic salary : 60000 x 20%=12000

• ₹5,000 (Statutory Limit) So Deduction = ₹5,000.

Entertainment allowance deduction is a restrictive deduction which may be claim by only some employees under certain situations.

4.4.3 Professional Tax [Section 16(iii)]

Professional Tax which is also referred to as employment tax, is a state-level tax on you're earning generated through profession, trade, calling or employment. The employer deducts it from the employee's salary and pays it to the State Government.

Deduction under Section 16(iii):

• Gross pay of the employee is reduced by the amount actually paid by him (deducted by the employer).

• The credit is taken the year paid.

• In case of an employer paid professional tax on behalf of the employee, RPM amount is first added in salary (perquisite) and allowed as deduction under Section 16(iii).

Legal Provisions:

• In terms of Section 16(iii) of the Act.

• Professional Tax is capped at ₹ 2,500 per annum pursuant to Article 276 of the Constitution of India.

• Deduction is allowed to the extent of amount actually deducted (subject to a maximum deduction of ₹2,500).

State-Wise Variation:

• Professional tax is not applicable in all the states (e.g., it is not levied by Delhi).

• Rates differ based on income brackets and state policies. In Maharashtra, for example, professional tax of employees with monthly salary > ₹15,000 is ₹200/month (except in February:₹300).

Important Considerations:

• The deduction is permissible if the tax has been paid in to the state government.

• If paid for second part of the year (due to admission or resignation), deduction is permissible up to that extent.

The work-related tax credit eliminates double taxation on labour income and considers compulsory state contributions on the employee's wage.

4.4.4 Relief under Section 89 for Salary Arrears

Explanation by Way of Illustration : Tax deduction as prescribed under Section 89 The' Income Tax Act is available to an employee who received salary arrears or paid in advance or pension in a lump sum which he was not likely before.

In the absence of such relief, taxpayers would pay higher tax even though the income is from earlier years when tax rate may be lower due to slab rate impact.

Applicability:

• Arrears or advance salary

• Arrears of family pension

• Commutation of pension

• Gratuity (received for past services)

• Compensation for termination of employment

Calculation Method:

Tax on total income including arrears to be charged in the year of receipt.

Tax on total income less arrears received during the year.

Subtract the higher balance (A) from the lower amount above.

Reckon tax for the above year (including arrears) in respect of each former year:

o With arrears

o Without arrears

o Compute the difference (B)

Relief = A – B (if A > B)

Procedure:

• The deduction is to be claimed in the year of receipt.

• The return filed by the taxpayer should include Form 10E online electronically at Income Tax Portal.

• Benefit shall be allowed only if such Form 10E is filed before filing the return.

Practical Considerations:

• The arrears break-up for the year is being given by the employers.

• Benefit under section 89 is computational, help from software /CA can be taken.

• If the tax effect is less in earlier years, there's relief; if not, no relief.

Section 89 brings equity in the system by avoiding penal taxation on account of the time lag between receiving income and smoothening tax liabilities across years.

4.4.5 Net Taxable Salary Calculation Format

In order to compute the taxability correctly under "Income from Salaries" a well-structured approach has to be followed which includes gross salary, deductions and exemptions under Section 16.

Net Taxable Salary Computation Format:

Step 1: Compute Gross Salary

• Basic Salary

• Dearness Allowance

• House Rent Allowance

• Bonus/Commission

• Special Allowance

• Overtime Pay

• Other taxable allowances

• Value of perquisites taxable as per Rule 3

• Employees' contributions paid through the employer in respect of the employees not covered by the Schemes (i.e., NPS, APS) not included above 5 Profits/ earning in lieu of wages/salary i.e gratuity, VRS compensation etc.

Gross Salary (A)

There can be an exception to Section 10: Step 2 Only—Less – Exemptions under Section 10

• HRA Exemption (Sec 10(13A))

• Leave Travel Concession (Sec 10(5))

• Allowance under Sec 10(14) read with Rule 2BB (like education allowance)

• Other individual exclusions (e.g., cost of living allowance)

Net Pay (B) = A - Exemptions

Step 3: Less – Deduction under Section 16

• Standard Deductions (Sec 16(ia)) – ₹50,000

• Entertainment Allowance (Sec 16(ii)) – Government Employees Only

• Professional Tax (Sec 16(iii)) – up to ₹2,500 or amount paid

Income from head "Salaries" (C) = B – Deductions under Sec 16

This total amount (C) is Net Taxable Salary and would be considered for the purpose of further income tax calculation, after including income from other heads as well as the Chapter VI-A deductions.

Knowledge Check 1

Choose the correct options:

1. What is the current standard deduction for salaried individuals?
   a) ₹40,000
   b) ₹50,000
   c) ₹15,000
   d) ₹60,000

2. Under Section 16(ii), entertainment allowance deduction is available to:
   a) All employees
   b) Private employees only
   c) Government employees only
   d) Self-employed

3. What is the maximum allowable deduction for professional tax under Section 16(iii)?
   a) ₹2,000
   b) ₹2,500
   c) ₹5,000
   d) ₹1,000

4. Section 89 relief applies to which of the following?
   a) HRA exemption
   b) Transport allowance

c) Salary arrears

d) Bonus

5. Form 10E must be filed for claiming:

a) HRA exemption

b) Standard deduction

c) Section 80C deduction

d) Section 89 relief

4.5 Summary

❖ Salary means that part of the income which is chargeable with tax under Section 15 of the Income Tax Act and consists of all payments received by an employee both in money as well as kind.
❖ Pay as you earn on due or receipt basis, the earlier of two.
❖ There has to be relationship of employer and employee for income to fall within head Salaries.
❖ Salary structure includes components such as basic salary, allowances, perquisites and profits in lieu of salary.
❖ ϖ Allowances may be fully taxable, partially exempt or fully exempt depending on its character and object.
❖ Perquisites are benefits, other than monetary ones, granted by an employer and are accruable interpretable as per certain valuation norms in Rule 3.
❖ There are some fringe benefits like rent free accommodation, ESOPs, concessional loans anything which is taxable other than medical facilities and GPH books or laptop issued for official purpose.
❖ Section 16 – Deductions from Salary Standard deduction, (where applicable) Entertainment allowance(for Government employees) Professional tax etc.
❖ Sec 89 relief is to be allowed for arrears or advance of salary as a relief in order reduce the tax liability on account of change in the slab rate.
❖ Employers are under obligation to correctly value and disclose the benefits in kind and deduct TDS thereon.
❖ Computation of net taxable salary Calculation of net taxable salary is a very important aspect while claiming exemptions and deductions.
❖ Complete documentation is necessary for Revenue/Depts not to decline or disallow exemptions/deductions.

4.6 Key Terms

1. Salary – Regular payment made by an employer to employee in exchange for services offered.
2. Franchise – Non-money benefit, given by employer to employee.
3. Allowance – A fixed sum of money paid for a particular purpose, whether or not the same is taxable.
4. Standard Deduction- Flat deduction from salary income, allowable under Section 16(ia).
5. Professional Tax – It is State Government tax on salary, which is also deductible u/s 16(iii).
6. Entertainment Allowance -An allowance for hospitality expenses in the course of duty and is partly deductible for public officers.
7. Section 10(14) – Relief under certain allowance in accordance with Rule 2BB :
8. House with No Rent – Employer-provided accommodation taxed as a perquisite.
9. ESOPs – Employee Stock Option Plans taxable at a lower rate on exercising.
10. Form 10E – Compulsory to be filled to claim relief under Section 89.
11. Rule 3 – Income Tax Rules relating to the methods of valuing perquisites.
12. Specified employee – An employee with a level of income or designation that incurs taxation on specific benefits.

4.7 Descriptive Questions

1. Discuss the chargeability of salary income under the provisions of Income Tax Act.
2. Distinguish between fully taxable, partially exempt, and fully exempt allowances supported by examples.
3. Explain the valuation of perks under Rule 3 of the Income Tax Rules.
4. Explain the eligibility and calculation to claim standard deduction.
5. Describe the circumstances and calculation when one claims relief under section 89.
6. TDS & reporting of perquisites What are employer responsibilities?
7. Explain the deduction in respect of entertainment allowance and professional tax under Section 16.
8. Draw up an assumption net taxable pay statement with deductions.

4.8 References

1. Income Tax Act, 1961
2. Income Tax Rules, 1962 – Rule 3 and Rule 2BB
3. Finance Act, 2018 and subsequent amendments
4. CBDT Circulars on Perquisites and Allowance Valuations
5. ICAI Study Material – Taxation (Inter and Final)

6. Government of India Official Publications and Notifications

Answers to Knowledge Check

Knowledge Check 1

1. b) ₹50,000
2. c) Government employees only
3. b) ₹2,500
4. c) Salary arrears
5. d) Section 89 relief

4.9 Case Study

“Salary Structure and Tax Implications – A Comprehensive Analysis”

Background:

Ms. Riya Sharma is a Senior Marketing Executive (MNC) and she works in Bengaluru. Her pay scale and emoluments for the FY 2024–25 is as follows:

• Basic Salary: ₹70,000 per month

• HRA: ₹30,000 per month

• Special Allowance: ₹15,000 per month

• Medical insurance premium (paid by employer) = ₹20,000

• Rent paid: ₹28,000 per month

• Employer’s share for RPF: ₹9,000/month

• Up to 3 months free housing when moved temporarily

• Arrears of ₹1,20,000 paid during the year towards FY 2022–23

• Professional Tax deducted: ₹200 per month

• Standard deduction applicable

• Employer has provided you the Form 16 with details of perquisites

Problem 1: To compute HRA exemption This is an example on how to calculate the HRA exemption.

HRA received = ₹30,000 × 12 = ₹3,60,000 Rent paid = ₹28,000 × 12 = ₹3,36,000 City: Bengaluru (metro) ⇒50% of salary

Salary for HRA = Basic + DA (when DA is there, in the absence of DA assume DD > Nil)

"50% of the salary = 70,000 × 12 × 50% = ₹4,20,000."

Rent paid – 10% of salary = ₹3,36,000 – ₹84,000 = ₹2,52,000 Exemption = The least of :

• HRA received: ₹3,60,000

• Rent paid less 10% of salary: ₹2,52,000

• 50% of salary: ₹4,20,000

HRA Exemption = ₹2,52,000

Taxable HRA = 3,60,000 – 2,52,000 = Rs.1,08,000

Issues Problem 2: 89 for Arrears / Cause of Action: Section relief under the head Relief (As per section 10(10C).

Arrears = ₹1,20,000

Received in Fiscal Year 2024-25, applicable to Fiscal Year 2022-23

Ms. Riya has to calculate tax for both the years including and excluding arrears and claim Section 89 relief

using Form 10E. Basic steps:

Tax with arrears (current year)

Tax without arrears (current year)

Tax in the last year (with and without arrears)

Relief = (Difference current year) - (difference previous year)

Employer furnishes breakup and tax projection sheet. Riya submits Form 10E along with her return to avail the relief.

Problem Statement 3: Calculate Net Taxable Salary.

Component Amount (₹)

Basic Salary (₹70,000 × 12) 8,40,000

HRA Received 3,60,000

Special Allowance 1,80,000

Perquisites (RFA for 3 months @15%) 2,62,500 × 15% × 3/12 = ₹9,844

Component Amount (₹)

Arrears Received 1,20,000

Gross Salary 15,09,844

Less: Exemptions

• HRA Exemption: ₹2,52,000

• Health Insurance: Not applicable (Official group policy)

Net Income after remedies: Incarnation =12,57,844 Less: Deduction Under S16

• Standard Deduction: ₹50,000

• Professional Tax: ₹200 × 12 = ₹2,400

Income under Salaries = ₹12,05,444

Reflective Questions

1. What is the importance of correctly structuring salary in context of Riya's tax liability?
2. Suppose, the equivalent rent free accommodation was not valued by the employer at its proper cost.
3. Why is filing of Form 10E mandatory for seeking relief under Section 89?
4. Was there a way she could have structured her salary for greater exemptions?
5. What papers are required to justify her HRA claim?

Conclusion

This case highlights the practical implication of tax rules on wages. Knowing and taking HRA Exemptions, perquisite valuation and Section 89 relief can help salaried class to reduce their tax liability. It also illustrates the significance of employer adherence, documentation, and timely submission of statutory forms for obtaining benefits along with legal implications.

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Unit 5 Income from House Property

Learning Objectives

1. To understand the meaning and scope of "Income from House Property" under the Income Tax Act.
2. To identify the conditions under which income is chargeable under the head "House Property."
3. To differentiate between self-occupied, let-out, and deemed-to-be let-out properties for tax purposes.
4. To compute the Gross Annual Value (GAV) and Net Annual Value (NAV) of a property.
5. To apply permissible deductions such as standard deduction, municipal taxes, and interest on borrowed capital.
6. To calculate taxable income from house property for various types of properties.
7. To analyze the treatment of unrealized rent, arrears of rent, and vacancy allowance.
8. To develop the ability to solve practical problems and case studies relating to taxation of house property.

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5.0 Introductory Caselet

“The Dilemma of Mr. Sharma’s Two Houses”

Bengaluru-based Ramesh Sharma is a salaried person who has two houses. One unit is his self-occupied house and second one is flat available in Pune, which was bequeathed to him by his parents. His Bengaluru house is occupied by his family and the Pune flat mostly lies vacant through the year as he has failed to get a tenant.

Mr. Sharma is also confused while filing his ITR (Income Tax Return). He also knows that, if certain conditions are met, the Income Tax Act obliges him to declare an income from a vacant property. Then, he knows that his taxable income can be brought down with deductions such as municipal taxes paid and standard deduction under Section 24.

The Hard Task for Mr. Sharma is:

• Whether he should consider the Pune flat as deemed let-out property, despite being vacant?

• How does he calculate the annual value and claim tax deductions accordingly?

• If the Pune flat was rented out, even for a portion of the year, would that make any difference?

As a result, he is confused on the proper tax treatment of his property and how his overall taxable income might be affected.

Critical Thinking Question

As Mr. Sharma’s tax consultant, how would you like him to compute income from his two houses? While answering, explain the rules for self-occupied property, deemed let-out property and allowed deductions.

5.1 Basis of Chargeability

5.1.1 Scope of Taxation under House Property [Sec 22]

The income from house property is taxed under the head "Income from house property", as per section 22 of the Act. Provided that the annual value of property consisting of building or land appurtenant thereto, of which future is not present ownership claimed byÂ assesse shall be chargeable to income tax under the head Â "Income from House Property. The rational in this charge is that the owning of a property, for occupation or not, generates by itself a potential ability to produce rent and as such this is spotted and taxed. The magic word here is of course this "annual value" and it does not include actual rent received but even the notional rent that a place in fact should fetch, subject to certain exceptions. This applies to residential and commercial property, such as houses, flats, offices, warehouses and shops - provided the building or the land on which it is built has the potential for rental income. The mere possession of such an open land alone, without any construction on it does not bring it within this head.

The ownership element is an essential condition for taxable possession and this limitation refers to both a legal ownership or otherwise. If so however negligible, even a notion of ownership as laid down in Section 27 wouldl suffice to bring it within the taxability net. This means that if in certain cases of transfers to a spouse or minor child with less than adequate consideration, where an inpartible estate exists, or property is held under a part-performance agreement, the law regards them as owner for tax purposes. Ownership also includes the right to belong to a co-operative society or company that gives property rights to an individual. The emphasis is not on physical possession, but the right to rentals (or other income) from land or the commons.

'Taxation under this head is exclusive' which means that the income from property cannot be taxed under any other head until unless the property is used by its owner for his own business or professional purposes. e.g If a Trader – trades from his owned shop, the rental value of such shop cannot be taxed under "House Property" because it is already a part of Business Income. But in case of the same shop being let out to someone else, rent will be taxable under this head. The concept is that the earning power of property acts as income unless you fall within exceptions.

Section 22 of the for Indian properties does not discriminate whether owner is resident in India. Thus, even a non- resident who has an Indian property shall be taxable on the annual value of such property. And for residents, it's even more than that in addition to the income received outside India so as long as relief is given through DTAAs. The worldwide income principle would prevent an individual from paying taxes on foreign property income. The law also provides for when property is still vacant. Even if the property is let out for no rent, Notional income can be charged for tax purposes, except in the case of Self-occupied house which will have annual value as nil.

Accordingly, the reach of Section 22 is broad. It includes not only actual rent but also deemed or notional rent, is applicable to both residential and commercial property holdings, applies to actual ownership and deemed ownership, and its enforcement would be irrespective of the purpose for which the premises is used. The doctrine of the ruling is that immovable property considered as a taxable capacity, and where it's not applied in a person's own business or profession, then such taxable capacity should be subjected to tax.

5.1.2 Conditions for Taxability: Ownership and Usage

Let's read on to know what are the tax rules and regulation for a property. The taxability of income will be explained here with respect to house property, which depends primarily upon two conditions i.e., (a) ownership of property, and the way it is utilized (?) (b). The ownership principle determines who shall be responsible for what, and the purpose of use decides how money is to be classed. The law is explicit that the assessee has to be a legal or deemed owner. Physical ownership is clear and pertains to the person in whose name documents of title (such as a sale deed or municipal records) are made out and also has the right to get rent. By contrast, the law goes further by way of deemed ownership to prevent taxpayers from evading tax liability by gratuitous transfers. To illustrate, when one spouse gratuitously transfers property to his or her spouse or minor child without any payment in return, any income arising therefrom is taxed in the hands of the transferor. Also the person holding property rights under part-performance agreement or a member of a housing co-operative society to whom flat is allotted, it is deemed that owner of a building.

Use of property is also a significant factor in chargeability. A property can be rented, self used or vacant. When the property is let out, then other than specified exceptions, actual rent received or receivable is charged to tax after various adjustments. The rule for self-occupied house property is the annual value is nil, and interest on borrowed capital is allowed as deduction but there are limits imposed to claim this deduction. Tant qu'on habite dans une seule maison, on ne se pose pas de question;) C'est une situation "originale" que d'occuper plus d'une maison. In such a situation the law allows for an assessee to treat up to two houses self-occupied with annual value of nil, whereas the remaining have to be treated as deemed let-out and taxed on capacity of notional rent. Empty properties complicate matters further because if they are not self- occupied, then in many cases they will still be taxed on the basis of notional rent, even though they lack actual income.

Another important stipulation: the property does not be used for the owner's business or profession. If the business is carried on in that asset by its owner, no income is also computed under this head. The value of the property is, instead, allowed to be realised under the head "Profits and Gains of Business or Profession"`where deductions as depreciation can be made. It avoids double taxation and connects income with its use. It should be noted that ownership is not simply possession. A tenant or lessee is not the owner under section 22 and income

from subletting by a tenant should be chargeable as 'Income from other sources' and not under the head 'houses property'.

Cases of co-ownership bring into focus, as well, the distinction between ownership and possession. If a property is co-owned, then every co- owner is to be taxed separately on the proportionate share allocated according to them income. The law guarantees that taxes will be uniform, and that the same property is not taxed more than once. In simple terms, "who earns" defines the liability whereas "who uses" determines whether such income is either taxable or exempt as well as to whom this income is to be eventually allocated. For example, if a person has three properties but lives in two and keeps the third vacant, what the law does is that it still taxes the third on deemed let-out.

Hence ownership keeps along with user in the determination of taxability of income from house property. Between them they prevent avoidance of tax liability by technical transfer devices or by not using properties. The provisions will clarify, prevent tax utility and find a way to tax potential income from properties under the Act.

5.1.3 Applicability to Residential and Commercial Properties

The levy under the head 'Income from House Property' is not restricted only to residential houses; commercial properties, including office premises/shop etc., godowns, shop-cum-godowns, warehouses, theatres building and similar other premises are also covered exactly in the same way as if they were residential buildings. The common factor is the presence of a building or land appurtenant thereto owned by assessee which is capable of earning rental income. For residential properties, the law differentiates between self-occupied and let-out houses. A self-occupied house is not taxed because its NAV is taken as nil subject to interest on borrowed capital being allowed as deduction for the same up to a certain limit. Precedents: A rented-out property, however, is taxed on the rent received or receivable while still providing for allowances such as municipal taxes and a standard deduction. Moreover, if someone has more than two residential properties, then the law also demands that such properties be considered as deemed let-out and get taxed on their notional rental value even if they are unoccupied.

Commercial property is equally susceptible to the operation of this head. House Property Income Rental income of the assessee for shops, office buildings and warehouses owned by him is a taxable house property income. However, it's a different story if the owner operates its own business in the commercial space. For example, in case a shop is not only self-occupied but also utilized for business by the owner it shall be excluded under house property income and added to business income. This is to prevent double taxation of The Same property in one year. But if the commercial property is rented out, the rental income attracts a tax under house property whether it is used for residential or business purposes by tenants.

Mixed-use properties, such as a building with a ground floor shop and an upper-floor residence, present additional difficulties. Income from each part is to be calculated separately because of the requirement of law. The shop component is taxed on rent or notional rent and the boutique residential and non-residential portion only gains of residential portions may be saved if self-occupied."). Also, some buildings offer a composite rent structure in which the building's rent includes services such as security, electricity or furniture. In those assessees, the law divides the rental outflow as house property income and service / furniture component is taxed under Other Heads. Where the two transactions are so inter-connected, entire income can be business income.

The use of this head is also restricted to matters (heritable estate) consisting in houses or land built upon. Unbuilt land devoid of any construction does not get covered and income from it may be subjected to tax under “Income from Other Sources” or “Business Income”, depending on the facts. Simultaneously, guest house or service apartments let out without providing any other service, is taxable as the income from house property. But if any services, including catering or housekeeping are provided, the earnings may be categorized under business head.

Ultimately, the law makes clear that anything immovable capable of deriving rent is covered — whether a living space or an office — so long as it is not itself used for the owner’s business. The all-facility coverage achieves tax neutrality between different categories of property as well and illuminates how various uses are treated for tax purposes.

5.1.4 Exceptions: Property used for own business/profession

Section 22 is widely worded, but it contains an important carve-out for property used by its owner in his trade or business. The basic idea is that no tax should be paid by an individual in respect of the notional rent from a property which is actually used by him for the purposes of his own business or profession. This will avoid double taxation and ensure the property’s contribution is acknowledged under the relevant head of income. For instance, if a doctor operates his own clinic on premises owned by him, then the property is considered to be one among other elements of his professional setup and income from it is taxed as “Profits and Gains of Business or Profession.” Further, if a person carries his retail shop from his house property itself, the notional rent of such retail shop also would not be taxed separately under house property.

It is easy to see why we made this exception. If the property is taxed under both heads, it would be hit with double taxation: once as a house property income and later as business income. No, the Income Tax Act provides that such value would be incorporated as a part of business income under the head “business” from which depreciation and maintenance can be written off. This permits business taxpayers to reflect the proper economic use of the property and obtain equitable tax treatment.

Partial property usage adds another dimension of complexity. If a property is utilized for both business and any other purpose, the income with respect to each portion should be computed separately. Signup to make a better source Lets start property and rented. For example, if ground floor of building is used by owner for running a clinic and first floor is being given on rent the clinic part will be excluded while calculating the house property income however rental income from the first floor (commercial portion) would be taxed as house property income. Similarly, if one portion

is being used for the purposes of self-residence, no annual value thereon is to be taken. This separation allows precise billing based on usage.

This exception also makes a clear distinction between possession and tenancy. An exception under this rule can be availed only by an owner. If an individual operates business from any rented premises, he cannot claim exemption on rent paid towards house property tax. Instead, the rent he pays is a deductible business expense for him, and the landlord has to pay tax on any rental income. This difference acts as a means of limiting the benefit to real owners; it also mitigates misappropriation.

Practically speaking, this provision is important to professionals, businesspeople. Offices, clinics, factories and warehouses which are owned by the taxpayer and used for business purposes are protected from tax liability under house property. Rather, they are a part of the business' fixed assets and thus subject to depreciation allowances for tax purposes. "This also ease compliance because the tax payers are not required to work out notional rental value where the housing property is used for business purpose.

Therefore, the exemption of property used in own business or profession strikes an equitable and reasonable balance under the regime of house property taxation. It eliminates double taxation, equalizes property use with the type of revenue and brings fairness to entrepreneurs and professionals.

5.1.5 Overview of Income Computation Process

Computation of income from the head "House Property" is methodical and consistent. First is to compute the Gross Annual Value (GAV). GAV is gross potential rental income of the property, which is derived from higher amount between actual rent received or receivable as well as expected rent taking into account passage of time/habitation factor with restrictions as per Rent Control Act. Expected rent is typically assessed based on municipality value, marketable value of comparable property and standard rent in case. In case house could not be let out for genuine reasons that cannot make any tenant available, the law provides to adjust in order to reduce the GAV.

The owner's municipal taxes are then subtracted from GAV to obtain the Net Annual Value (NAV). Local taxes consist of property tax and other fees imposed by local governments. Such

taxes must be paid by the owner during the year to be eligible for deduction. So NAV is the earning power of the property once statutory taxes and duties are taken into consideration.

And then the law further permits two standard deductions under Section 24. The first is a straight out 30% of NAV, regardless of how much you spent on repairs, maintenence etc. That acknowledges that owning property has an inevitable cost and makes it easy to comply without having to calculate actual spending. Next deduction is of interest on borrowed money under section 24(b). Borrowing costs for loans taken to buy, build, repair or improve the property are tax deductible. There is a limit of ₹2,00,000 per annum on the deduction for interest on housing loan in case of self-occupied property (certain conditions apply like construction should be completed within 5 years etc.). For let-out properties, deduction is allowed in full for the entire interest but set-off of losses against other heads of income is limited to ₹2,00,000 and the balance can be carried forward for eight years.

The end is to determine the amount of taxable income. The NAV after deductions under Section 24 Taxable Figure. For self-occupied houses, where GAV is nil the only deduction allowable is interest on borrowed capital which results in notional loss under this head in most of the cases. This loss can be adjusted against other income, subject to specified ceilings, thus providing tax deductions for individuals with housing loans.

Special cases offer more detail about the computation. For self occupied properties same is nil – fair as no income earned. "In the case of deemed let-out properties, notional rent is taken into account, so that ownership of more than one house does not go undertaxed." For properties that continue to be vacant despite attempts to lease them, vacancy allowance is a measure to ensure tax fairness so that taxpayers are not taxed for money they never received. Such modifications render the computation flexible and comprehensive, that represent practical situations.

To conclude, the calculation of income under house property is methodical and clear. It mixes a valuation of notional income with deductions that allow for necessary expenditures and cost of financing. It does this in order to tax property owners rigorously based on their true income-generating power of their properties, while making certain exemptions such as self-occupation, vacancy or interest on loans.

5.2 Annual Value Calculation

5.2.1 Meaning of Annual Value [Sec 23]

Central to the taxation of income from house property is the concept of annual value. The expression “annual value” used in S.23 of the Income Tax Act should have the connotation which is usually associated with that term -namely, it is the potential ability to produce income in terms of rental. It's not simply based on the rent you actually receive, but on what the property could realistically bring in the open market. The purpose is to tax the property for

what it's worth, rather than merely the rent it produces by contract, and hence that hempstead room cheat shall not have the right to play fast and loose with us by entering into leases at a low rental in order to lessen its taxable value.

Yearly rent is, in effect, the nominal income that may be derived from a property. For example, if an owner rents out a house at rent which is lower than the current prevailing market rate, the taxman can calculate the AV based on his expectation of what should have been received as rent unless protected by rent control laws. yielding the minimum annual value of a rent preventing undervaluation. This principle guarantees that properties are being taxed according to their true earning value not some guess or a manipulated number.

"Annual value" would have to be calculated differently depending on whether property was let out, self-occupied or deemed let out. Normally for let-out properties, the actual rent received is compared with expected rent. The annual value is taken as nil for self-occupied houses because self-occupied houses do not yield any income. For 'deemed let-out properties' i.e. where a taxpayer has more than two houses for residential use, the Act dictates at least one or more house to be taxed as deemed let out and is valued on notional rental basis every year.

Note, annual value ≠ actual income. It is a legal figure calculated with reference to municipal valuation, fair rent, standard rent under rent control laws and actual rent received. The goal is to be able to reach a fair approximation of the property's rentability. In addition, since the statute is a flexible one, it provides for valid exceptions like property vacancy where real rent collected may be lower than assumed rent. Where that is so the lower rent actually prevailing (if there is a bona fide vacancy) will be taken over.

Therefore, Section 23 created the formula for computation of annual value taking into account notional capacity and actual income. It guarantees that taxation is not artificially raised or unfairly lowered, and that income from property investment is taxed in accordance with the real economic value of ownership. Now the concept of annual value is a product of ownership and taxable capacity to ensure uniformity and equitability in computation of income from house property.

5.2.2 Factors Considered: Fair Rent, Municipal Value, Standard Rent

The annual value of a property, several major parameters being used to reach a fair and justifiable amount. These reservations, are, including the Municipal value, fair rent and standard rent under rent control laws. There are benchmarks to measure the notional rental potential of the property from each of these, and law strikes a balance between all those benchmarks with regard to real rent in determining the annual value.

Rateable value is in turn based upon municipal value, which is assessed by local authority for the purpose of calculating tax. It is the authority's judgment on what the property could

command in rent, and it helps set a marker for tax purposes. But municipal value is not determinative, as it does not always adequately represent the current market value. So it's "normalized" in light of other evidence.

Fair rent The rent that comparable houses in the same or adjacent neighborhood would create on the open market. This is a significant point, in that it tells us much of the demand / supply and corresponds to what the.

competitive rates for rentals in the area. The fair rent makes certain that the value of the property correlates to real time markets rather than fanciful numbers. But the question of fair rent is debatable in some cases, since evidence is necessary to show similar rents for similar premises.

Where rent control laws are in effect, the minimum rental charge is important. India Rent control laws in India may restrict the rental amount which can be levied for a property. Even though the fair rent or municipal value indicates a different figure, nothing in the law can prevent that annual value from being higher than the standard rent. This means they are not being taxed on an income it would be illegal for them to receive. For example, if the fair rent of a flat is ₹20,000 a month but the standard rent under rent control is ₹15,000, then the annual value cannot be charged in excess of ₹15,000.

This balancing of factors is necessary to arrive at a fair and reasonable evaluation of annual value. In general, the fair rent or municipal value, whichever is higher but not exceeding standard rent when applicable, is considered as "the expected rent of a property". The former figure is then contrasted with the amount actually received; the greater of the two is taken to be the annual value, somewhat discounted for vacancy.

This multi-factor method properly under includes nor over values the annual value. The Municipal valuation ensures it is the law binding, fair rent keeps pace with the market and standard rent recognises a roof over the head cannot be as permanent structure cursing or deterring the access of any other citizen. Both combine in a mechanism that bars underreporting by landlords and shields taxpayers from overly notional assessments. In this way, these municipal value, fair rent and standard rent give a complete and harmonious basis to ascertain the annual value of an estate.

5.2.3 Expected Rent and Actual Rent Received

One way to compute the annual value is by comparing expected rent of property to the actual received or receivable rent. This helps to ensure that the income reported for taxation is both based on a proper market figure and the true value of the transfer.

Expected rent is calculated based on municipal, fair and standard rents which have already been described. It is the fair rental value of the property that can be obtained in the open market, pursuant to rent control regulations. It refers to the rent that the owner actually

receives, or is entitled to receive, from a lease. Under the Income Tax Act, annual value is determined at the higher of anticipated rent or received rent, unless conditions of vacancy are present.

The reasoning for this rule is simple. If the actual rent is in fact greater than expected rent it provides a more accurate picture of what the property can bear, and therefore should be taxed. For example, if you expect rent to be ₹2,00,000 per year but owner instead makes his own plan according to which he wants rent to be ₹3,00,000.

succeeds in letting out the property for ₹2,40,000, the latter figure is taken as annual value. Conversely, if the real rent is below the estimated rent it may arouse concern of under-declaration or sub-letting. In these situations, the act states that anticipated rent must be taken into account unless any shortfall resulted from actual vacancy.

This contrast also avoids evasion of the tax under collusion. For instance, a landlord can rent property to a family member for artificially low rent. Where such rent is substantially lower than the expected rent, the assessing officer may determine the annual value on the basis of expected rent. Where an order rent control laws of standard rent are in force the standard rent is limited to what can be charged and no owner can be taxed on any sum in excess than that fixed by law.

In a period of arrears or non-realization of rent the difference between expected and actual rent is also worth considering. Rent due but not collected despite bona fide efforts of the landlord shall not exceed the annual value. Likewise, rent received in arrears is taxed only when it is actually received under another provision. Thus, only "income derived from" real and receivable income will be taxed, which would still respect the properties capacity to pay.

So the comparison of statutory rent and actual rent shall ensure that the computation of annual value is rooted both in legal principles and economic reality. It bridges the difference between theoretical and realized income, with room for adjustments in cases of vacancy and legal limitations. In making the higher figure determinative, the statute guarantees an even and fair application of tax.

"Activity: Evaluating Annual Value in Practical Scenarios"

Consider three different situations: a residential flat let out at rent lower than market rate, a commercial shop that remained vacant for part of the year, and a self-occupied house with an outstanding loan. Apply the rules of annual value computation under Section 23 to each situation. Compare expected rent with actual rent received, account for vacancy if applicable, and determine the final annual value in each case. This activity will help you practice integrating municipal valuation, fair rent, standard rent, and real circumstances to arrive at a fair computation.

5.3 Valuation of Various Property Types

5.3.1 Self-Occupied Property – One and Multiple Houses

The treatment of self-occupied property by the income tax act is really interesting as houses occupied by us don’t make money/revenue on their own but are classified as a separate category under which it’s imputedly taxed i.e., Income from House Property. Self-occupied property: This type of building is owned and used by the assessee for their personal use. Where a property is of such a nature that it cannot be let, it shall under section 23 be deemed to have no annual value. This is because when you have a property, there is no income flowing from the same and altogether, it makes no sense to tax what qualifies as notional rent on the house where you are staying.

Till FY 2019–20 tax laws allowed only one house as self-occupied and all other houses were treated as rented. But, commencing from A.Y 2020–21 such law have been changed and now two houses could be claimed to be self occupied. This amendment acknowledged the emerging reality that some people may be fortunate enough to have more than one home which they use themselves; for example, they may live in their constituency and own a flat or house elsewhere because of work commitments. By allowing for two houses, the law granted respite to middle class tax payers who would otherwise be subject to notional taxation on a property that was, in reality, not let.

If more than 2 houses are used by him as self-occupied, the assessee needs to exercise an option and specify any two of the house property for the purposes of rule1(4)(d) with nil annual value. The balance of properties are taken as deemed let out, that is they are valued on notional rent even if in a vacant state. This way, if you have a million homes in the portfolio, as long as they were residential properties at some point during the year, no tax avoidance can occur. The assessee is entitled to decide which house(s) he wishes to treat as self-occupied and when the other unit(s) are having higher expected rental value, it will be a part of the strategy to opt for treating those units having potential fetch of rent at higher values, so that notional income liability can be eliminated from assets/sorties.

In the case of self-occupied properties, while the annual value is nil, law permits a deduction for interest on money borrowed. This deduction can be claimed under section 24(b) subject to a maximum cap of ₹2,00,000 per year based on the fulfillment of conditions that ensure that loan was taken for buying or construction and completion was within 5 years. If they're not met, you can only claim ₹30,000 for deduction. This deduction normally gives rise to a notional loss under the head “House Property” which is allowed to be set off against other income to the extent of ₹2,00,000 and the balance is carried forward.

Thus, AOV homes, although exempt from AV tax actually matters due to the interest on housing loan deduction. With more than one house, the assessee will have to balance the comfort of claiming some as self-occupied vis-a-vis other's being deemed let out. This fine distinction has direct implications on the final taxabe income and is an example of how

owning more than one property brings about both advantages and responsibilities in the eyes of law.

5.3.2 Deemed Let Out Property – Second/Additional Property

Deemed let out properties gets in to picture when you own more than two self occupied house property. In such cases, while two houses can be treated as self-occupied with nil annual value, however the others are deemed let out even if they may not have been on rent. Its current law also prevents someone who owns several properties from dodging taxes simply by declaring them all to be for personal use.

In case of deemed let out property, annual value is determined on notional rent. This means that a choice between the market value and fair rent (or standard rent where applicable) is made to assess the higher of these. This notional rent is now subject to tax (regardless of whether the actual house or building is unoccupied or occasionally used by owner for personal purposes. The reasoning is that extra homes are potential income-generating assets, and owning them signifies an ability to earn rental income, and such should be taxed to make for a more fair system.

Its important to note that, for the purpose of deemed let out property, actual rent is inconsequential unless the house itself is actually let in some part of the year. If let, the actual rent received is taken into account..with provisos for an expected rent regime. If not let, the hypothetical rent is then used. This expected rent can be estimated by the assessing officer with the help of locality details, municipal records or similar rentals.

Highly impactful are the implications on housing loan interest deductions. In the case of deemed let out property, whole of the interest on borrowed capital is allowed as deduction u/s 24(b). In case of self-occupied properties, the deduction is limited to ₹2,00,000 while there is no monetary cap when it comes to deemed let out properties. But a loss can be set off against other head of income only up to ₹2,00,000 and the balance is carried forward for eight years. Deemed let out classification is thus a bane and boon trend– it's tax on notional rent for the owner in exchange of which he gets higher deductions on interest.

For people with several investment properties for wealth or capital gains, deemed let out provisions are very important. Even where for whatever reason such properties are not rented out, the law prohibits their ownership from being tax neutral. Holding multiple vacant houses would also be discouraged, which might otherwise distort the housing market. By taxing notional rent, the provision impels owners to make these properties economically productive by essentially renting them out and thus benefiting both economic activity and the owner.

So, at least in broad strokes - I think that deemed let out offers a good balance between fairness and practicality. They save revenue loss to the exchequer from hundreds of vacant

houses, allow deduction on actual cost like interest and do not permit individual taxpayer to declare income at variance with potential of property holding.

5.3.3 Let Out Property – Full Year or Part Year

when the property is let out, either on one or several occasions or otherwise, during the whole year, or any part of the year..its income can be regarded as income being received and accrued…. Subject to provisions for computation of annual value. Let out properties are the simplest category when it comes to house property tax since they generate income. However, the equation still reflected expected rent versus actual rent as required by law to avoid underreporting.

In case of a house property let out through out the year, calculation starts with computation of Gross Annual Value which is higher of Expected Rent and Actual Rent Received subject to standard rent. Deducting the municipal taxes actually paid by the owner from this figure gives you the net annual value. After this, a 30% standard deduction and interest on borrowed capital is permitted under Section 24. Thus, taxpayers obtain relief for those unavoidable expenses and are taxed on the actual earning capacity of the property.

In part year lettings, the treatment will vary according to whether the property was empty during the rest of the year. Where the property was vacant despite reasonable efforts to let it, vacancy allowance applies and actual rent received is applied if less than estimated rental. For instance, 8 months of a house being let out at ₹15,000 per month with 4 months lying vacant is factored into the actual rent of ₹1,20,000 even though the expected rent for an year might be ₹1,80,000. This is to ensure equity by not taxing the hypothetical rent for the untenanted period.

In such a case, the property is considered to be let out for the entire year. This is to say that annual value is calculated on the rent of expected rent, not self-occupation. Nil annual value self occupation is not possible in such mixed use scenarios. This rule is to avoid the manipulation where a taxpayer may otherwise claim that for a part of the year, he himself used to occupy the property and would have restricted his own tax liability.

Another situation is when rent has been paid in advance or arrears. These may be taxed in the year of receipt, regardless of the year to which they pertain (Section 25A); unrecovered rent, provided it is genuinely bad, can be excluded under certain conditions (like tenancy being bona fide and process for eviction pending). If such unreceived rents are subsequently received, they are taxed in the year of receipt regardless of whether or not the property is still owned by the assessee.

Thereby, the handling of let out property assures that tax is based on actual income earned providing at the same time fairness in situations of vacancy or deficit. Whether the house is let for the whole year or part way through, there is a desire to capture what it’s actual earning

potential would be without providing an unnecessary burden on owners when rent isn't actually earned.

5.3.4 Composite Rent (with Services or Amenities)

Composite rent: Rent received for a property that is used as not just for the building but also included in the charges are services added by the owner. These services could be furniture, security, lift upkeep, water supply and cooling, etc. In such cases, the income computation is not that straight as whole of the rent cannot be considered as income from house property.

It differentiates inseparable composite rent and separable composite rent for the purpose. Where the letting of the property and services are so interrelated that they cannot be severed, it gives rise to inseparable composite rent. Or you could be leasing a furnished apartment with central A/C and door security services under the same contract. For those services and property that cannot be separately calculated, business income is the whole amount. By contrast, United Airlines distinguishes between heritable pool rent and separable composite rent, the latter comprising composite property lease charges only where services are optional or capable of easy separation. For instance, if a shop is rented out for ₹50,000 and maintenance services are charged at an extra cost of ₹5,000 then it would take ₹50,000 as income under house property and the rest amount will be treated as business or other income.

This distinction being drawn on the rationale that income from house property should represent no more than the inherent rental value of building and appurtenant land and not by activities which are merely commercial. By moving these two aside, the law assures an equitable proposition and that one does not overinflate house property income figures with unrelated charges.

Composition of rent issues are common in commercial letting, serviced apartments and corporate housing. For example, many commercial landlords offer office space as well as services such as housekeeping, a cafeteria or internet. If these partnerships are indistinguishable, the income is charged under business head. But if rented out as a separate element, the rental portion alone is treated as house property. This distinction is relevant in deciding who (and under what circumstances) is eligible for deductions. For house property income, the government has stipulated only a 30% standard deduction and interest on borrowed capital, but for business income a wider array of deductions are allowed including staff salaries, electricity and repairs.

In other words, in a composite rent situation taxpayers must scrutinize the lease to determine if the services can be separated from the nonseparable feature. Erroneous characterisation could result in disagreements with tax officials and forfeiture of valid deductions. The rule to be followed is that the rent on the building shall be separated from charges for services. In

cases where separation cannot be made, the whole of the income is considered as business income. This would make the tax system reflect the actual nature of income and not create any artificial distortion.

5.3.5 Real-life Scenarios and Tax Implications

No discussion of the taxation of property types is complete without real-life examples illustrating these rules. Think about a person who has a house in Delhi he may live in; another flat in Mumbai that he uses sparingly and a villa in Goa rented out seasonally. In such a case the house in Delhi and flat in Mumbai can both be considered as self occupied, with nil annual value, u/s 23(4) (this section has been amended to provide that two houses are deemed to be used by an assessee exclusively for his own residence). The Goa villa, however, must be declared let out or deemed let out as the case may be, if rented during the year. If it is let Actual Rent would be taken into account, please see expected rent rules. Where vacant, estimated rent is expected unless seasonal vacancy can be proven as real.

Take for instance a businessman who has a warehouse for his trading business and an office premise which he leases out to another company. The warehouse was exempt from taxation as it is used for business, but the office rental was taxable as income from house property. The businessman would be able to claim municipal taxes, the standard deduction and interest on any loan financing the office building — but not for the warehouse.

Mixed rent is also a standard practice. Sample 4 Assume a Company has taken rent of office premises ₹1,00,000 per month with facilities for air conditionings, security and furniture. If they can not be fractionated, the whole.

₹1,00,000 as business income could be subject to tax. But if the contract specifically states ₹80,000 is rental for office and ₹20,000 as service charges, then only ₹80,000 will be taxed under house property and ₹20,000 will be taxed under business or other sources.

There are also real-world implications for those who own many houses. A lot of people buy houses as a way to add to their wealth. For instance, the person who owns four flats and two of them are kept vacant has to pay notional tax on vacant ones, deemed to be let out. As onerous as this may seem, the law mitigates it by providing for a full interest deduction on loans for such properties, with set-off rules. This shows how tax policy affects investment in the housing market, and not just mobilizing tax revenue.

Hence, life situations illustrate the implications of such definition. They show how classification into self-occupied, deemed let out, let out or composite rent influences tax incidence and deductions and the compliance burden. Taxpayers and their advisers need to grasp these subtleties when planning, and for fairness in applying the law.

Knowledge Check 1

Choose the correct options:

1. How many self-occupied houses can be declared with nil annual value?

a) One

b) Two

c) Three

d) Unlimited

2. When is a property treated as deemed let out?

a) When vacant

b) More than two owned

c) Used for business

d) Self-occupied

3. For part-year letting, which income is considered?

a) Expected rent

b) Standard rent

c) Actual rent

d) Municipal value

4. Composite rent is taxed as business income when:

a) Rent only

b) Services inseparable

c) Two houses owned

d) Self-occupied

5. Which deduction is fully allowed for deemed let out property?

a) 30% NAV

b) Municipal tax

c) Interest on loan

d) No deduction

5.4 Deductions Allowed under this Head

5.4.1 Standard Deduction @ 30% of Net Annual Value [Sec 24(a)]

As per the provision of Section 24(a) of the Income-tax Act, one of the most important deductions which is available under "Income from House Property" head is standard deduction @ 30% of NAV (Net Annual Value). This deduction is allowed regardless of the amount spent by the landlord to maintain or keep up the property. The premise of the change is to benefit all tax payers evenly for the inevitable charges associated with ownership and upkeep of immovable property, without needing them to be in a position to evidence real expenditure incurred, says Gable.

To decode the process of this deduction, let's first understand that when you compute income from house property the starting point is to calculate Gross Annual Value (GAV) of the asset, which is considered as rental income. The GAV is reduced by municipal taxes actually paid for the determination of NAV. Standard deduction of 30% is based on this NAV. After deducting the statutory allowance in respect of repairs and maintenance, whether such expenditure was incurred by owner or not.

Eg., If the NAV of a property is ₹4,00,000, then tax payer needs not to have proportionate deduction on account that has been claimed by dependents or owner.

₹1,20,000 (30% of NAV), even if just ₹40,000 is spent on repairs or no repair are done at all." Similarly, even if the taxpayer has spent ₹3,00,000 on a major strengthening or renovation the deduction would be limited to ₹1,20,000. This is to avoid the administrative problems, controversies and inconsistent treatment among taxpayers that may arise out of the application of a meaning of words subsequent to its establishment.

It should also be noted that this standard deduction is to be permitted in relation to let-out and deemed let-out properties only. Under a let-out property, there is no such deduction since NAV already includes the ULV. In case of self-occupied properties, when the annual value comes to nil, this deduction does not arise because NAV becomes zero itself. The logic is that the let out/in deemed income on a house property is being taxed under the head "income from house property", whereas you do not get such income in respect of a self-occupied property, so the law does not provide for any deduction/incentive in respect of its notional

value except for what was discussed in point e to (ii) above i.e. interest deduction under Section 24(b) above.

This fixed rate of 30% has been in place for over a decade. Though it looks like a hard number, the allowance is based on acknowledgment that there can be significant variance in the cost of repairs, based primarily upon age, size and location of the property. Standard deduction relieves the assessees of corresponding detailed inquiries and litigation. It acknowledges, too, that it costs something just to have a property that isn't strictly quantifiable each year (from structural wear and tear to depreciation of fittings).

Thus, the 30% standard deduction is one of most the taxpayer beneficial in house property taxation. It has the virtues of certainty, simplicity and an acceptance that property ownership brings costs that cannot be avoided without requiring all owners to produce documentation or proof of expense. It is intended to strike a balance between the state's need for taxation and the owner's desire for fairness and simplicity.

5.4.2 Interest on Borrowed Capital [Section 24(b)]

Another significant deduction under the head "Income from House Property" is interest on borrowed capital. Section 24(b) grants relief to taxpayers who have borrowed money for the purpose of acquiring, constructing (including adding to existing structures), repairing, renewing or reconstructing the property. This deduction factors in the requirement to borrow/spend when acquiring immovable property as well as how interest payments shrink the real return on investment for such acquisitions. In allowing such deduction, the law is designed to tax net income and not gross receipts.

The deduction is allowed for a loan from banks, financial institutions, employer or even any individuals on the condition that the borrowing is genuine and has been used solely to invest in property. The deductible portion would depend on the type of property. In the case of let out or deemed to be let out properties, 100% interest paid on the loan will qualify as deduction without any monetary cap. So people are more keen to invest in rental properties, because taxpayers can deduct their rental income against large interest costs incurred throughout the term of the loan especially at the start.

For self-occupied houses, the deduction is limited to ₹2,00,000 annually (provided conditions are satisfied), else it would be ₹30,000. The eligibility conditions include that the loan must have been availed on or after 1st April 1999, for acquisition or construction and within five year from the end of financial year in which loan was taken,Construction and acquisition should be completed. If it is not met, the limit of deduction is ₹30,000.

It is important to note that the deduction is available on an accrual basis, i.e., interest payable for the year would be deductible even if it has not been actually paid as long as liability for the same had accrued. It is provided so taxpayers will not be confronted with discrepancies

between obligations on loans and computations of taxes. In addition, other costs of borrowing, including processing and service fees, are considered interest and may be deducted. However, repayment of the main part of the loan rebate is not deductible from this section, however it might be susceptible to deduction under Section 80C(wherever-ever applicable).

This provision also dovetails to house property loss in set-off. Where the aforesaid deduction is such that it leads to negative income under this head, such loss may be adjusted against any other income (other than 'Income chargeable to interest') up to a maximum limit of: i.

₹2,00,000 in a year. If there is any loss in balance the same can be carried forward up to 8 years from the year in which it first occurred for set-off against income of house property. Interest deduction is a way to do that and thus is as much a planning tool as it is a break.

Therefore, section 24(b) is a relief to the borrowers, brings tax in line with economic principle and promotes housing finance by promoting individuals to acquire house property on loan. It strikes a reasonable balance between providing tax relief to taxpayer and ensuring fiscal prudence by restricting the deduction for self-occupied houses, while at the same time full deduction is available in respect of rented house property.

5.4.3 Limitations of Deduction for SOP vs LOP

A critical differential feature for the deduction to be made is regarding the restriction with respect to self-occupied property (SOP) and let-out property (LOP). The law distinguishes between these categories to account for the difference in that self-occupied houses do not produce income, while let-out houses are income-generating assets.

For self-occupied property; the annual value taken is nil, that implies no rent is charged. However, tax payers are eligible for a deduction of interest on borrowed capital upto ₹200,000 per financial year if the loan has been taken for purchase or construction prior to 1st April 1999 and this construction is completed within five years. The deduction is limited to the lesser of if either or both of these conditions are not satisfied.

₹30,000. This cap makes sure that taxpayers do not claim an excessive number of deductions against a "notional" income, helping preserve the government's revenue while providing some relief to home-owners.

It's a different story for a let-out property though, where there is no such cap. You can deduct all the interest that you paid during the year, no matter how much money it was. This accepts that the income received from let-out is actual and the interest paid is a real expenditure for earning that revenue. For example: Let annual rent from the property be ₹4,00,000 and interest payable be ₹6,00,000 The entire amount of Interest may be claimed as deduction by the assessee 56 or (-)2,00,000.

₹2,00,000 under this head. But only ₹2,00,000 of this loss can be set off against other income in the same year (the rest can be carried over) under existing rules.

The difference between SOP and LOP also adds some strategic considerations for taxpayers. Home owners often like to put high-loan properties as let out(because they can get full interest deduction and are not taxed on rent (as income) in this

properties of lesser loans as self occupied. That way, they can minimize tax efficiency within the law.

Further, if tax payers own more than one house property then in those cases two can be treated as self-occupied and others may be deemed to have been let out. The interest ceilings are then as follows: limited in the first case (for SOP), and unlimited in the second one (for LOP). This provides planning opportunities, particularly for those with more than one housing loan whose property needs to be classified in a manner where tax is minimized.

Hence, the differing caps on deduction of SOPs and LOPs represent a trade-off between fairness on one hand and prudence in public financial management. They deliver relief to those hardworking real homeowners and ensure that taxpayers who have investment properties are not unfairly prevented from deducting the real cost of their borrowings.

5.4.4 Pre-construction Interest and Its Spread

The Income Tax Act also allows deduction of pre-construction interest that is, interest payable on borrowed capital for the period prior to completion of construction or acquisition of the property. Since, during this pre-construction period, there is no rental income received but the interest gets accumulated during the year(s), then law permits to claim such accumulated interest over 5 successive years (starting from the year in which construction/acquisition got completed) in equal installments.

Pre-construction interest is the amount of interest which is paid on borrowed fund starting from the date of borrowing till the last day of financial year prior to the financial year in which construction completes or property acquired. For example, if a loan is borrowed in June 2019 and construction is finished in September 2021 the pre-construction period is from June 2018 to March 2021. Interest for this period is added to and allowed as deduction in five equal instalments beginning from the Assessment Year 2022–23.

This five-year spread is intended to align the deduction with the income-earning capacity of the property. Such a provision is necessary to prevent taxpayers from trying to claim all the pre-construction interest in any year, which could result in distortions and very large tax revenues losses for government. The deduction is phased in, which means that the law spreads relief in a structured and fair way.

Please note that the preconstruction interest is eligible only in case of loan taken for purchase or construction, and not, say repairs, renewal or reconstruction. Secondly, the aggregate cap of ₹2,00,000 for self-occupied properties as a whole will apply i.e., both the interest for current year as well as the apportioned pre-construction interest should not exceed this limit. In the case of let-out properties, you are able to claim 100 percent of the interest paid as a deduction - subject to set-off rules.

The pre-construction period interest also interplays with housing loan planning. For instance, it could be that folks are borrowing and finishing courses such as to take every deduction they can, or to satisfy the 5-year completion.

Failure to finish construction on time can lead to a significant drop in permissible deduction, and therefore this provision becomes an important aspect of homeowners' or investors' tax planning.

Did You Know?

"Pre-construction interest is not lost if construction is delayed, but it must be spread over five years after completion or acquisition. However, if construction exceeds the specified five-year limit, the deduction for self-occupied property may shrink drastically from ₹2,00,000 to just ₹30,000."

5.4.5 Restrictions under Section 80EE and 80EEA (brief mention)

In addition to Section 24(b), taxpayer may also be entitled to another deduction for interest under Section 80EE and Section 80EEA which are some of the specific provisions introduced by the lawmakers to encourage housing with first time home buyers. These are not part and parcel of the calculation of income from house property but come as deductions over and above ur basic exemption under Chapter VI-A.

Section 80EE had originally provided for additional deduction of interest on housing loans upto ₹50,000 sanctioned during certain financial years subject to conditions that the loan amount did not exceed a particular limit and value of the property was below a threshold. The latter was followed by section 80EEA that further enhanced the benefit by providing an additional deduction of ₹1,50,000 for loans sanctioned during the period between April 2019 and March 2022 so long as the stamp duty value of house does not exceed ₹45 lakh and the taxpayer is a first-time home buyer.

These provisions operate as an overlay over the deduction available under section 24(b). For instance, if you are the owner of a self-occupied house, then your limit is ₹2,00,000 under Section 24(b) and beyond that; if applicable to you but only upto ₹30,000.

₹1,50,000 under Section 80EEA. This effectively reduces the total tax payable and makes housing more affordable." However, the taxpayer will have to satisfy that loan complies with the time limits and requirements as specified since these provisions are designed as concessional provisions in context of times.

It reflects the government's desire to breathe life into housing and first-time buyers; increasing affordability and access, but ensure the relief is only available to those that genuinely meet criteria for qualification.

5.5 Summary

- In the Income Tax Act, 1961 it is dealt with under Section 22.
- 6 The principle of charge is the annual value of the property including buildings and lands appurtenant thereto which are owned by the assessee.
- Ownership may be legal or beneficial; beneficial ownership arises in situations such as gift to spouse/minor child for inadequate consideration.
- Properties are divided into the 3 categories – self- occupied, let out and deemed let out for tax calculation.
- Annual value for self-occupied house is nil (less interest on loan deduction is allowed, s.t. prescribed limit).
- GAV: can be calculated as the higher of expected rent and actual rent (subject to vacancy allowance) in case of let-out properties.
- Municipal taxes paid by the owner are deducted to arrive at Net Annual Value (NAV).
- Sec 24 deduction 30% of NAV and interest on borrowed amount included in sec24.
- Composite rent with inseparable services is taxed in business income & separable services are bifurcated.
- Pre-construction interest is allowed as deduction in 5 equal installments, commencing from the completion year.
- Additional concessions are permissible under Section 80EE and 80EEA in case of first home buyers.
- Loss under this head is permissible to be set off against other income so far as it does not exceed ₹2,00,000; exceeded loss can be carried forward for 8 years.

5.6 Key Terms

1. Annual Value – The hypothetical value of a property which is capable of generating income, for tax purposes under Section 23.
2. Gross Annual Value (GAV) – It is the higher of Expected rent or actual rent received, after reducing vacancy.

3. Net Annual Value (NAV)Gross Annual Value of property minus the amount of Municipal taxes paid.
4. Note: Self-Occupied Property (SOP) – Used for own residence, annual value nil.
5. Deemed Let-Out Property (DLOP) – More than two SOPs treated as notional rent yielding assets.
6. Let-Out Property (LOP) – Any property on rent partially or fully, and income being taxed as let out.
7. Standard Deduction (Sec 24a) – Flat 30% deduction on NAV, irrelevant of actuals.
8. Interest on Borrowed Capital (Sec 24b) – Housing loan interest is part of this, restricted in case of SOP but not in case of LOP.
9. Composite Rent- Letting out including service charges; not to be taxed as BRTC split up if it can, otherwise business income.
10. Vacancy Allowance – Decrease in annual value if property is vacant despite attempts to find tenant.
11. Pre-construction Interest -Interest paid prior to completion of property, admissible in 5 equal installments.
12. Arrears of Rent – Rent realised subsequent to earlier years, taxed in year of receipt under section 25A.

5.7 Descriptive Questions

1. Discuss the ambit of taxes under section 22 with example regarding deemed ownership.
2. Classify self-occupied, let-out and deemed let out rest for income calculation.
3. Explain the treatment of vacancy under Section 23 adding practical examples.
4. What is the calculation of Gross Annual Value? What is the part of municipal value, fair rent and standard rent?
5. Discuss in brief Section 24 deductions with respect to SOP and LOP.
6. Explain the way composite rent is treated in tax classification.
7. What is pre-construction interest and how can it be claimed as tax deduction?
8. Explain the effect of interest on borrowed capital in tax planning for landlords.

5.8 References

1. Income Tax Act, 1961 – Sections 22 to 27.
2. Circulars and Notifications issued by CBDT relating to house property income.
3. Taxmann’s Direct Tax Laws Manual.
4. Singhania, V.K., Direct Taxes Law and Practice.
5. ICAI Study Material – Paper on Direct Taxation.

6. Practical case law examples from Indian courts on House Property taxation.

Answers to Knowledge Check

Knowledge Check 1

1. b) Two
2. b) More than two owned
3. c) Actual rent
4. b) Services inseparable
5. c) Interest on loan

5.9 Case Study

"Taxation Issues Arising from Acquisition Of More Than One Properties – Mr.

Background

Mr. Rajesh Verma, a senior executive in Mumbai, owns four homes:

• Property A: The house home overlooks with his family in Mumbai.

• B - A holiday home at Lonavala, which was occasionally used.

• Property C: A Pune flat that is lying vacant all year round.

• Property D: A flat in Bengaluru, on rent to a software professional.

Mr. Verma has taken loans for Properties A, C and D: He is unable to calculate income under the head "House Property" properly while filing the tax return.

Issue 1: Distinguishing between Different Types of Properties

• What are the properties that can be considered self-occupied?

• How about the others for tax purposes?

Solution

• Under an amended law, Mr. Verma is entitled to declare two houses as self-occupied. Both Property A (Mumbai residence) and Property B (Lonavala holiday home) are selected as SOPs with nil annual value.

• Property C (Pune flat) should be considered as deemed let out property (DLOP) even though it is vacant, in view of the fact that only two SOPs are permitted.

• D (Apartment in Bengaluru)= Let out property {LOP} and the actual rent received is considered for tax.

Issue 2: Calculating Gross and Net Annual Value

• What is the method of computing GAV and NAV for each property class?

Solution

• SOPs (A&B): Annual value = Nil; deduction available is only interest on loan (Chapter ON THE INCOME UNDER THE -12) CALIFORNIA FORMCODE PUBLICATIONYEAR(Single Individual...

₹2,00,000 cap).

• DLOP (C): GAV adopted is the higher of municipal value or fair rent (subject to SR if applicable). Since empty, if actual rent is $0, it does not matter; GAV is established by anticipated rent. Alpine then calculates the NAV less any municipal taxes paid there from.

• LOP (D): GAV higher of the expected rent or received rent. It is not available as payment on account since the apartment is rented all year round. Taxes and Duties are deducted to calculate NAV.

Issue 3: Deduction and Loss Issue 42.

• What deductions can be claimed by Mr. Verma and how should he deal with housing loan interest?

Solution

• SOPs: Housing loan interest relief for self-occupied property upto ₹2,00,000 in aggregate. If even that amount of interest is earned, the excess is disregarded.

• DLOP (C): Full interest on loan to be allowed, but loss set off against other heads limited to:

₹2,00,000; balance carried forward.

• LOP (D): Full interest deductible. Any loss arising from house property head is also considered in the same manner, with carry forward allowed for up to eight years.

• 30% of the NAV is allowed as deduction in respect of DLOP & LOP.

Reflective Questions

Then why does the law not allow self-occupation of unlimited houses, it permits only 2?

How does the notional rent and deemed let-out rules help in avoiding tax evasion?

If we have multiple houses with loans, how should we plan?

How is fairness in taxation ensured by the treatment of vacancy?

If Mr. Verma had factored service charges into Property D's rent, what would be the tax effect?

Conclusion

The Verma case underscores the inherent complications in house property taxation mainly when multiple properties are owned by an individual. Categorization of property as SOP, DLOP or LOP has direct effect on taxable income. Such deductions like municipal tax, standard allowance and interest on borrowed capital at 12%, offer some relief subject to statutory limits. The law introduces equity by taxing notional income for deemed let-out properties, restricting SOPs to provide relief and allowing full deductions on income-generating assets. Tax planning is essential in order to minimize the tax burden within the framework of laws, which includes making well-informed decisions on SOPs and optimizing borrowing costs for tax deduction.

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Unit 6 Profits and Gains of Business/Profession, Capital Gains & Other Heads

Learning Objectives

1. Understand the scope of "Profits and Gains of Business or Profession" under the Income Tax Act, including what constitutes business income and professional income.
2. Identify allowable and disallowable expenses in computing taxable profits from business and profession.
3. Differentiate between business income, capital gains, and other sources of income, and understand their respective tax treatments.
4. Explain the concept of depreciation and amortization as deductions in business and professional income.
5. Analyze the provisions related to Capital Gains, including short-term vs. long-term gains and indexation benefits.
6. Apply exemptions available under capital gains (e.g., sections 54, 54EC, 54F) to minimize tax liability.

Content

6.0 Introductory Caselet

6.1 Profits and Gains from Business or Profession

6.2 Capital Gains

6.3 Income from Other Sources

6.4 Summary

6.5 Key Terms

6.6 Descriptive Questions

6.7 References

6.8 Case Study

6.0 Introductory Caselet:

“Tax implications of diversified income sources”

Mr. Arjun, a 45-year-old entrepreneur who heads a medium-sized manufacturing company. His sources of income in the financial year 2023–24 were varied:

• Out of his business he made a net Income of ₹18,00,000 after routine expenses but some private living expenses were also treated as business expenses.

• He sold an old machine (held for 3 years) at a profit of ₹2,50,000.

• He held listed shares as investment and after 14 months, also sold the same with a long-term capital gain of ₹3,20,000.

• He earned ₹90,000 in dividend income from Indian companies.

• He also received a lottery gift worth ₹1,50,000.

Now that I am trying to draw up the tax calculation, he is not so sure of himself though:

Which income would be covered under Profits and Gains of Business/Profession, Capital Gains, and Income from Other Source.

The deductibility/exemptibility of the reliefs pertaining to his capital gains.

The proper handling of personal expenses when they’ve been expensed as business-related on the return.

Critical Thinking Question:

If you were Mr. Arjun’s tax advisor, how would describe each receipt of income under the appropriate head and what would be your suggestions to ensure that his tax is calculated as per law and correctly?

6.1 Profits and Gains from Business or Profession

The income head expressly provided for under the Income Tax Act, 1961 bearing the name "Profits and Gains from Business or Profession" has turned out to be one of the most extensive and important heads of income. It relates to the taxation of income derived from business, industry or profession. Being unlike the other heads (such as, say, "Salaries" or "Income from House Property") in the sense that it has an unlimited scope and complicated calculation due to number of inclusions, deductions and adjustment to be made. Legislature has the intention to tax all those profits which are earned on systemic economic activity, in whatever form it may be called as that of business or profession, for bringing equity in the taxation system.

6.1.1 Definition and Scope [Section 28]

Profits and Gains section 28 as profits chargeable under "profit and gains of business or profession" (PGBP) income are defined by the Income Tax Act. The terms business and profession have a different connotation under the Act. Business as contemplated by Section 2(13) is trade, commerce, manufacture etc or any adventure or concern in the nature of trade or commerce. The term is broad enough to cover any manner of regularized business enterprise, "including single transactions constituting such as an adventure in the nature of trade. On the other hand, profession as defined by way of Section 2(36) means an occupation that requires some sort of intellectual skill, experience or training viz. law, medicine, engineering and accountancy etc.

The reach of Section 28 is not limited to only realises from business. It includes all receipts which are of the nature of profits and gains (except agricultural income) but not many others. These comprise payment for termination of contracts, export incentives, duty drawback and perquisites in kind. For instance, if a professional gets a free house or if company gives car to its directors for business use, then value of these benefits is included in income. Under the same head, also, are to be classed insurance claims received for stocks-intrade destroyed and profits realised from speculative business.

The provisions of this section are also attracted to the remuneration, commission, and interest received by a partner from a firm as it is taxed directly in the hands of the partner. It also covers both governments subsidies and inducements to do business where not expressly exempt. On the other hand, some incomes are excluded from PGBP including agricultural income, casual or hobby income such as winning lottery and profit on sale of investment.

It has also been consistently held that business can be established through one transaction, if entered into with a motive or purpose of gain. For example, the Supreme Court ruled that purchase and resale of land in an organized way is business activity as opposed to capital gain. Accordingly, the range of Section 28 is deliberately wide and encompasses all profits or gains which can be related to business or professional undertaking.

6.1.2 Basis of Chargeability

Tax is a levy of the State on real income, whether accrued or received and the chargeability of income under head "Profits and Gains from Business or Profession" is guided by the method of accounting followed by the assessee. Sections 28 through 44 establish the machinery for the computation of such taxable income. The mercantile system and the cash system of accounts both are recognized by law. Merchants are also taxed when revenue is earned, not when it actually is collected, and they can write off expenses in the periods that they are incurred. The cash system, in contrast, means that income is taxed when it's received and expenses are deductible when they're paid. The method of accounting is at the option of the assessee, but once employed it must be pursued consistently.

The idea of previous year is so essential in taxation. Business income for one financial year (previous year) is taxable in the next immediate year (assessment year). For example, for the FY 2024–25 income will be taxed in AY 2025-26. This keeps business income always being tracked on a yearly basis, which is necessary for accurately comparing gains and costs.

Another important theory is that we tax only real income. Fictitious income or imaginary gains are disregarded unless they are expressly so provided by the law. For instance, plain appreciation in the value of closing stock would not be taxable unless such stock were to be sold but according to valuation rules, it is still required that closing stock be debited at cost or market price whichever may be lower for truthfully reflecting business income.

Composite revenues also belong to this category, if the main one is of a business nature. For instance, if machines are let out including services for maintenance, the composite receipt is treated as business income and not income from house property. It had to be in accordance with Income Computation and Disclosure Standards (ICDS), which are meant for consistency and prevent fudging of numbers.

There are also judicial decisions that further define the chargeability matrix. For example, the judiciary has held that remuneration for loss of agency is taxable under the head business income and rental income on commercial assets can be treated as PGBP in case letting is part of business operations. So, the statute takes care that such chargeability under this head is extensive, just and according to the true economic manifestation of the assessee's ventures.

6.1.3 Allowable Deductions [Sections 30 to 37]

Under the head "Profits and Gains from Business or Profession" severals deductions are allowed under the provisions of Incom Tax Act. These deductions serve to limit the income for tax to only the actual earnings after true business outlays are deducted. Sections 30 to

37 describe these deductions and their range is also wide enough to embrace virtually every kind of outlay laid out wholly and exclusively for the purposes of business or profession.

Section 30 deals with Rent, repairs and insurance of premises let out for use in business or profession. In case the assessee has taken a shop/office on rent, the amount of rent actually is deductible. Also, business premises repairs and insurance are deductible unless they are capital in nature. Section 31: Repairs and insurance of machinery, plant, furniture It covers repairs and insurance of machinery, plant and furniture so that any expense needed to retain a working asset is available as deduction.

Section 32 on Depreciation is dealt with separately at 6.1.5 below. Section 33 to 35 are dealing in respect of certain allowances, namely, development rebate and expenditure on scientific research etc., amortisation of preliminary expenses. For example, research conducted on the company's premises that is directly related to the business may qualify for 100% deduction.

Fundamental is the general deduction provision, Section 37(1). It provides that any expenditure not laid down in Sections 30 to 36, which is incurred wholly and exclusively for the purpose of business or profession shall be allowed as deduction provided it is not capital in nature and also not personal. This broad provision will also bring the modern and innovative business expenses, such as advertising campaigns, consultancy fees or software subscriptions, into charge. But it does not specifically authorize the payment of expenses made for purposes that constitute an offense or are contrary to law.

Some common allowable deductions include:

- Rent, rates, taxes and repairs of business premises.
- Stock, machinery and premises insurance premium.
- Wages-salaries, and bonus to employees.
- Interest on borrowed capital, if borrowing is for business.
- Commission and brokerage paid in respect of business.
- Payments for services such as fees to auditors, consultants and attorneys.
- Bad debts deducted (to the extent such amounts previously were included in income).

The courts have read Section 37 in favor of taxpayers where expenditures bore a reasonably direct relationship to the conduct of business. Courts have even allowed deduction of some of foreign travel for the directors if the purpose is to explore new market and that fact existed. Additionally, care is taken to eliminate personal costs even if directors or owners incur the expenses.

Therefore, Sections 30 to 37 work in combination to maintain that the tax base is fair and accurate representation of actual commercial profits. The touchstone is whether the expense is ordinary and necessary for business (and not capital, personal or disallowed).

6.1.4 Disallowed Expenses [Sections 40 and 40A]:

While deductions under Sections 30-37 are allowed for a wide range of business activities, the Act also contains specific provisions for disallowances intended to prevent misuse of deductions. Sections 40-40A list items of expenditure that cannot be allowed, even if incurred for business use. Section 40 deals with cases of absolute disallowance. One common point is the payment of interest, salary, bonus, or commission to the partners of a firm that is not in accordance with the terms of the partnership deed, or which exceeds the percentage calculated as per Section 40. Similarly, income tax paid by the assessee, or wealth tax, is not allowable as a business expenditure. One more disallowance is from Section 40(a)(i) that does not allow income tax levied on the profits to be deducted before arriving at the final profit. Especially, if the tax is deductible at source 410, but has not been deducted or even after being deducted has not been paid in time, then such an amount cannot be allowed until the compliance is made. Section 40A Disallowance of certain expenses:. Section 40A disallows the expenses that the Central Government does not believe to count as a business expense. Section 40A 2 forbids companies from paying an amount above INR 20,000 in cash APA, draft, bank transfer to a person in one day. It is measured per transaction separately. Otherwise, the paid money is a valid expense, then the overpaid part is a business withdrawal in this context. Some examples:

• Personal expenses of the assessee, even if they were spent during a business trip.

• Tax liability and fines for breaking tax legislation.

• Payments for not providing documented services in timeshare or the expenses of the timeshare itself,

• Paying illegal fees, for example, ransom to a kidnapper or a prosecutor.

• Provision for doubtful debts, which is not equal to writing off a bad debt. Unaware that the precedents clarify these disallowances. For example, the courts say that while a genuine business expense is considered genuine, any payment that has statutory payments cannot be an expense. Even an innocent payment, such as a punishment for the illegal act, is consistently considered illegal.. Thus, while business expenditure is allowed under sections 30-37, it is determined that all business expenditures must be used appropriately from these sections. This effectively creates the balance that only actual business expenditures can be used as a deduction.

6.1.5 Depreciation under Section 32 – Block of Assets, WDV Method

Depreciation is a significant deduction available under the Income Tax Act, because in aspects it takes into account the wear and tear of business assets over time. Depreciation on tangible assets such as building, machinery, plant including furniture and on intangible assets like patents, copyrights, trademarks and goodwill owned and used for business purposes is allowed under section 32.

• The block of assets system is a peculiar feature under Indian tax law. Depreciation is not calculated on each assets; instead, the assets are categorised introducing block concept wherein depreciation would be calculated depending upon nature of thee asset and rate prescribed. A block of assets can have more than one asset with the same rate, e.g. for machinery at 15%. Purchases and sales for the year are added or deducted to the block, then depreciation is computed on the WDV of the whole block.

• Depreciation is charged on the reduced value of assets each year under the WDV method and thus depreciation keeps reducing with time. This is because of the economic reality that new assets lose their value more quickly than old ones. The depreciation rates are specified in the Income Tax Rules and they differ depending on asset type. As an example, computer may depreciate more quickly than buildings.

There are special rules for assets acquired in the course of the year. Where any asset is used less than 180 days in a year, only half of the normal required depreciation is admissible to ensure that claims are equitable. Also, after a block has been vacated (an asset no longer remains in it), your remaining balance becomes short-term capital loss.

Depreciation serves multiple purposes. It has an incidental but very beneficial effect on taxpayers in that it gives relief to them by distributing the cost elements of assets over their economic life, thus avoids large profits being overstated and only true income taxed. Precedently, it has been laid down that even assets which are kept ready for use and not put to actual use are entitled for depreciation if they form part of the same business apparatus.

Accordingly Section 32 provides statutory allocation of cost of assets and the block system and WDV method make for easy administration and no manipulation.

6.1.6 Presumptive Taxation Schemes [Sections 44AD, 44ADA, 44AE]

In order to minimize compliance burden on small taxpayers, the Income-tax Act has incorporated various provisions like section 44AD, section 44ADA and section 44AE. These schemes enable such taxpayers to forego the obligation of maintaining regular books of accounts and declaring income at a certain percentage of turnover or gross receipts.

• Section 44AD applies to small businesses, other than professionals, with a turnover of up to ₹2 crore. In this scheme, income is assumed at 8% of turnover (6% for digital receipts) and no other expense is allowed. Those who opt for this scheme are exempted from keeping any books ofaccount or having it audited.

• The presumptive scheme under section 44ADA is being extended to professionals with gross receipts up to ₹50 lakh p.a.— which comes as a relief for certain professionals such as doctors, lawyers, engineers and accountants. Income is assumed to be 50% of receipts and no other deductions are permitted. This eases the burden on people of moderate means to comply.

• Section 44AE is applicable to businessmen who are into the business of plying, hiring or leasing goods carriages. Income from the vehicles is assumed at a flat rate per vehicle per month, based on vehicle type. This simplifies and obviates the necessity for complicated record-keeping on small shippers.

Presumptive taxation has immense advantages — it eliminates paperwork, compresses the filing to a single line and gives certainty about one's taxable income. However, it comes with restrictions. You are not eligible for any deductions, with losses being able to be carried forward in most cases while opting for presumptive schemes. They are also required to pay advance tax, and have to declare income as per the scheme, if they do not then unless they get out of the scheme, they may be barred from entering it again for a certain period.

These are schemes to promote voluntary compliance by a section of small taxpayers, besides encouraging transparent business in transaction-intensive sectors and bring them into the formal regime. They're a compromise between what's easy for taxpayers and protecting revenue.

“Activity: Analyzing Business Scenarios for Taxable Income”

Each student will be assigned a short case study representing different business and professional situations, such as a small shop owner, a freelance consultant, a transport operator, or a partnership firm. The student is required to independently analyze the case by identifying the sources of income chargeable under "Profits and Gains from Business or Profession," classifying allowable deductions, pointing out possible disallowances, and deciding whether presumptive taxation applies. After completing the analysis, the student will prepare a written explanation, justifying their treatment with relevant sections of the Income Tax Act. This activity strengthens individual problem-solving skills and

enhances practical understanding of theoretical provisions by directly applying them to real-world business cases.

6.2 Capital Gains

Huge superficies : Capital Gains are one of the major source under the Income Tax Act, 1961. If an individual disposes of a capital asset for a price greater than the cost price, such overprice or profit is taxed as capital gain. This return is subject to special provisions in which capital assets, short-term and long-term gains, methods of computation, and exemptions to encourage certain types of investments are all carefully defined. The reason why you tax CG is to tax value increase on assets - It’s fair (you should be taxed on your gains, and this does not mean only in a Patient Capital way) and 2. Why would you incentivize the waste of money?

6.2.1 Definition and Scope [Section 45]

S. 45 is the charging section of capital gain. so as to provide that the income by way of profit or gains (as computed in accordance with the provisions contained therein) arising from transfer of a capital asset effected in the previous year shall be assessed under the head "Capital Gains" and such income shall be deemed to be also the income chargeable thereunder in that previous year and, subject to certain conditions (adverting thereto shortly), all amounts falling within clauses a) to d) above should first be deducted from the full value of consideration received or accruing as a result of such transfer.

Its main principles are:

• Existence of a capital asset: Capital Asset" is defined u/s 2(14) and comprises all the property (including supply rights except as mentioned in two category goods referred to in provisions or commodities) owned by the assessee (whether gratuitously or otherwise), whether connected with business or profession. These are land and buildings, plant and machinery, shares, debentures and securities and goodwill. However, it’ll leave out certain things like stock-in-trade, personal effects (except jewellery/painting/art) and agricultural land in the rural areas.

• Transfer of a Capital Asset: Transfer is defined widely in terms of section 2(47) which includes sell, exchange, any relinquishment of rights, the extinguishment of rights, taking possession or compulsory acquisition also to include conversion into stock-in-trade or even part performance under Section 53A and so on not being defeat transfer within the meaning as defined within this Act.

• Profit or gain: The sale consideration minus the cost of acquisition plus cost of improvement (indexed, where applicable) constitutes capital gains.

• Timing when tax : Capital gains will be taxed once amount is transferred currently not necessary in the year of receipt of value for transfer.

Over the years, scope of taxation of capital gains has been extended significantly to cover even indirect transfers (such as transfer of shares in a foreign company where 'value' is substantially derived from assets located in India). Similarly, there are also provisions for taxation when shares are bought back, preference shares are converted into equity and securities redeeming.

The concept of transfer has been broadened through judicial construction. For example, a right that goes unredeemed without necessarily involving a sale (e.g. tabling of shares), may generate capital gains. Further, though agricultural land in rural area is not to be included within the definition of capital asset, urban area's land is taxable on its transfer.

Therefore, S.45 is a device to bring within the tax net profit from capital assets in whatever form it may take in that such accrual of wealth by disposal of capital asset should not go untaxed.

6.2.2 Short-Term vs. Long-Term Capital Gains

Computation and taxation are by reference to short-term vs. long-term; this classification is not arbitrary, but instead essential. It is the age of the property that makes a difference here, and there are differing thresholds in place depending on what kind of asset.

1 A short-term capital asset means a capital asset held by an assessee for a period not exceeding thirty-six months immediately following the date of its acquisition. But the time is 12 months in case of listed securities, units of equity-oriented mutual funds and zero-coupon bonds. (for land and building the same was restricted to 24 months) equally in case of immovable property like land and building. Any assets held longer than this period are considered long-term capital assets.

Thus:

• Immovable property (land, building, house property): if less than equals to 24 months short-term; else long term.

• Listed equity shares, equity mutual funds, zero coupon bonds: Short- term (≤ 12 months); long-term (> 12 months).

• Any other assets (jewellery, unlisted shares or debentures, machinery): short-term if held for 36 months.

The distinction matters because:

• Any short-term gains are taxed at normal slab rates (except in case of certain shares, where STT is paid and 15% tax is there).

• Long term capital gains are typically taxed at concessional rates, eg 20% with indexation and exemptions are available under different provisions such as section 54.

For instance, if a person sells the listed equity shares after 15 months of holding them, the gain will be long-term. Conversely, if 7 months in those same shares are sold – the gain is short-term.

The classification also has an impact on eligibility for indexation benefits. Indexation can be applied on such cost of acquisition and improvement in the value of long-term capital assets (except specified securities). Short-term capital gains are however, without indexation.

This differential between the two is what creates fair taxation, taking into account the speculative nature of short-term trading versus investing over a longer period and encouraging taxpayers to hold onto assets for a lengthier portion of time in order to help stabilize the economy.

6.2.3 Cost of Acquisition and Cost of Improvement [Section 55]

The generation of capital gains involves calculation on two important fronts i.e., the cost of acquisition and the cost of improvement. Section 55 explains those terms and suggests other methods where the real cost cannot be ascertained.

The cost of acquisition is the price paid by the assessee for acquiring the asset. This is in addition to the purchase price and various other incidental expenses such as stamp duty, registration fees, brokerage and legal charges. Where the asset is received as inheritance or gift or under a will, however, its cost to the previous owner shall be considered as its cost of acquisition. The same is also the position in respect of bonus shares or right shares, for which the Act lays down precise norms for computation of cost. For example, the cost of bonus shares is considered nil and the cost of right shares is the actual subscription paid.

The cost of enhancement is the capital outlay for new construction or alterations to an asset that increases its value. Normal maintenance and repairs or costs incurred in the ordinary course of business are not eligible; it must be expenditures that enhance the useful life, use, or value of the asset. 4: Cost of Improvement For example, building an extra floor on a building or making major alterations to the property comes under cost of improvement.

With effect from 1 April 2001, the CBDT has prescribed a scheme for computing fair market value of assets where no such value is available based on valuation by a registered valuer which is in principle an attempt to give relief for older assets. This leaves appreciation that took place prior to modern capital gains rules untaxed.

In certain cases, the purchase price of acquisition is not determined (goodwill on trademarks created internally). Section 55 provides that in this case the cost is deemed to be

nil and full consideration is considered to be capital gain. In the same way as for self-produced assets (e.g., ten- ancy or loom hours), cost is set equal to zero unless one purchases.

These rules work to bring tax recognition into line with economic reality by including historic purchases, 116 transfers at no cost and special cases where cost is ambiguous. They avoid conflict and provide certainty in calculating taxable capital gains.

6.2.4 Indexed Cost and Exemptions [Section 54 Series]

Indexation Basis : The cost of acquisition and improvement are adjusted for inflation to arrive at the indexed long term capital gains. This is done by using the Cost Inflation Index (CII) declared by the government. III Indexed cost of acquisition: (a)Indexed cost of acquisition is to be calculated by deducting indexation from the actual costof the asset.

The mechanism is used to ensure that only actual, and not just apparent, gains are taxed. The benefit of indexation is generally available for all long-term capital assets, with the exception – inter alia – to certain securities such as bond/debentures (other than capital-indexed bonds and sovereign gold bonds).

In addition to indexation, the Act contains several other exemptions under Section 54 series that facilitate re-investment of the capital gain:

Section 54: Eligible for exemption to individuals and HUFs on sale of residential house property on reinvestment in other residential house within prescribed timelines.

• Section 54B: Agricultural land by an individual or HUF on sale if gains are re-invested in actual purchase of other agricultural land.

•Section 54EC: Exemption if long-term capital gains are invested in NHAI or REC bonds within six months of transfer, up to a maximum of ₹50 lakh.

• Section 54F – If net consideration (not just gains) from the sale of a long-term asset (other than residential property) is invested in a residential house, exemptions are available.

• Section 54D, 54G, 54GA : Relief on compulsion compulsory acquisition or shifting of industrial undertakings.

These exemptions are subject to conditions in terms of investment timelines, lock-in period for new assets, and use of capital gains account scheme if the investments are not made by the time return is filed. Breaching conditions will cancel the exemption.

So indexation and exemptions have a balancing act: on one hand they compensate for inflation to achieve fair taxation, while on the other they incentivise reinvestment in productive or socially useful assets like housing, infrastructure bonds and farmland.

6.2.5 Capital Gains on Special Assets (e.g., shares, property)

Some assets enjoy specific provisions on their treatment as capital gains in view of their importance and wide prevalence. Shares, securities and immoveable property are classic instances.

It was only for listed equity shares and equity-oriented mutual funds that long-term capital gains of more than ₹1 lakh would be taxed at 10% under Section 112A, if securities transaction tax (STT) is paid. Those assets, usually listed securities to which STT (securities transaction tax) was paid, if sold within a year were taxed at 15 per cent under Section 111A.This friendly rate is in the nature of an incentive for investing and trading in capital markets. But these assets do not enjoy the indexation benefit.

Long-term capital gains for unlisted shares are taxed at 20% with indexation and short-term in the normal slab. Holding period for unlisted shares is 24 months.

But when it comes to immovable property, the capital gain is taxed depending on whether the asset in question held more than 24 months or not. That's where a special anti-abuse provision comes in – if the sale consideration declared is lower than value of property for stamp duty purposes, the latter shall be deemed to be full value of consideration so undervaluation will not help in lowering taxable gains. There are analogous provisions under Section 43CA for stock-in-trade and Section 56(2)(x) for persons receiving the undervalued property.

Special provisions also apply for certain assets, particularly for depreciable assets (section 50), under which the capital gain is always considered to be short-term even if held over the long term. Different holding periods and rates apply for securities such as government bonds, sovereign gold bonds, zero coupon bonds, etc.

The taxation of capital gains on special assets embodies the two-pronged dual purpose behind this move – stemming revenue leakage, while encouraging investments in priority areas like stock markets or housing.

6.2.6 Computation and Tax Rates

Appreciation of gains involves a certain method prescribed in the Income Tax Act. The method includes the following steps:

1) Ascertain the full value of consideration received or accrued consideration from the transfer.

2) Deduct the costs of transfer of the consideration, including brokerage, legal charges, and stamp duty.

3) Deduct the cost of acquisition and possession of the asset, with indexation in certain cases.

4) The result is the capital gain.

If the result is on the negative side, it is capital loss, which has its rules for a set-off and carry forward. Short-term capital loss can be set off with both short-term and long-term capital gains, unlike long-term capital loss. The losses can be carried forward up to 8 assessment years.

The tax rates under the taxation process vary with the asset and the duration held as follows:

1) Short-term capital gains : Normal slab rates, 15% for listed equity shares/mutual funds with STT.

2) Long-term capital gains : Generally at 20% with indexation; for listed shares/mutual funds, 10% without indexation beyond ₹1 lakh exemption.

3) Special assets : Zero-coupon bonds at 10% without indexation; depreciable assets at STCG.

Similarly, surcharge and cess are applicable for income slabs. Non-residents also have specific rules such as taxation on gains from specified assets without indexation or currency adjustment under certain conditions. The methods ensure a structured, just, and transparent acquisition of capital gains while fostering compliance and reinvestment.

Knowledge Check 1

Choose the correct options:

Q1. Which section is the charging section for capital gains?

a) Sec 28

b) Sec 45

c) Sec 54

d) Sec 55

Q2. What is the holding period for immovable property to be treated as long-term?

a) 12 months

b) 24 months

c) 36 months

d) 48 months

Q3. The cost of acquisition for bonus shares is considered as:

a) Nil

b) FMV

c) Purchase price

d) Indexed value

Q4. Which section provides exemption on reinvestment of capital gains in residential property?

a) Sec 54

b) Sec 54B

c) Sec 54EC

d) Sec 54F

Q5. Short-term capital gains on listed shares with STT are taxed at:

a) 10%

b) 15%

c) 20%

d) Slab rate

6.3 Income from Other Sources

The chargeable salaries are 201 – Tax on income allotted to five significant heads other being Income from Other Sources under the Income Tax Act, 1961. This head works as a repository — all incomes which are not income under the heads of salaries, house property, profits and gains of business or profession and capital gains, then such income taxed under

this head. By keeping this residuary head, the law makes sure that no income is left untaxed only because it does not squarely and comfortably fit into any of the other heads. This sidebar's definition is broad by design and should include traditional receipts as well as less typical receipts.

6.3.1 Scope and Residual Nature [Section 56(1)]

Head I 3 Section 56(1) is the charging provision for this head. It provides that income of every kind which is not to be excluded from the total income under this Act, if it is not chargeable to tax any other head, shall be chargeable to tax under "Income from Other Sources." This provision is essential as a matter of tax equity and coherence to capture the value in any receipt of request made that can escape taxation through classification loopholes.

For instance, the income from term deposits is not salary, business profits or capital gains. It was reiterated that sitting fees received by company directors is not a business income unless, they are professionals rendering services. As both these revenues are comprised under this head.

The deictic nature of this head is understandable as follows:

• Unclassified income: Whenever the income is not possible to be classified clearly under any head, it arrives under this head.

• Covers casual and windfall receipts: This includes everything from gifts to lottery winnings to money one does not expect, so some of that unearned income is taxed.

• Covers incomes specifically by law: Dividends; interest on securities; and the composite rent of letting furniture with buildings are specifically legislated to be charged under this head.

Case law The words "residual" income do not mean literally what is left behind after everything else has been removed; they merely denote that which is not properly taxable under the other clauses". If not, it defaults to Other Sources." This fact renders Section 56(1) an umbrella provision, leaving no taxable income uncovered.

6.3.2 Specific Incomes Taxable Under this Head

While the overall rule is contained in Section 56(1), Section 56(2) enumerates certain incomes which are compulsorily taxable under this head. These receipts are specifically described so as to avoid any ambiguity and to achieve parity in tax treatment.

The main categories are the following:

• D ividends: Dividends paid by companies are taxable in the hands of shareholders. Income that was hitherto exempt on account of dividend distribution tax (DDT) is now taxed at the recipient's slab rate, therefore bringing in a degree of progressive taxation.

• Lottery, crossword puzzle and game show winnings: These are subject to flat 30% tax under Section 115BB, without the option for tax deductions. The belt-tightening is an example of the feast-or-famine mentality that affects such income.

• Interest on securities: Earnings from debentures, corporate bonds or government securities are mentioned specifically here, unless it is treated as business income for businessmen whose business consists of investment in securities.

• Composite letting of assets: In case machinery, plant, furniture and buildings are let together and such letting is not business then rent received there from would be taxed under this head.

• Sub-letting of property: If a tenant sublets the property and earns income, it is not "house property" but instead taxed under "Other Sources.

• Payback of loan or windfall: Compensation for breaking contracts, or any other windfalls that can not be categorized elsewhere are taxed here.

• Gifts and deemed income: The transfer without consideration or inadequate consideration is covered under Section 56(2)(x).

These classifications emphasize the fact that this head is organized. Although it is treated as a leftover basket, some portions of income are specifically thrown in here automatically by law so as to have clarity on its treatment.

Did You Know?

"Lotteries, crossword winnings, and gambling incomes are taxed at a flat 30% rate with no deductions, exemptions, or adjustments allowed. This reflects the government's intention to treat such windfall gains differently from regular income sources."

6.3.3 Gifts and Deemed Income [Section 56(2)(x)]

Section 56(2)(x) is important for preventing tax avoidance through gifts and transfers at an undervalue. It does this by bringing transfers of money or property for inadequate consideration into the hands of the recipient for tax purposes.

The rules are:

• Monetary gifts: If a person receives any amount in cash or cheque from anyone (or more) without any consideration and the aggregate value of such sum is more than ₹50,000 during the year, the whole of such sum would be taxable.

• Immovable property acquired without consideration: The immovable property is fully taxable if the stamp duty value exceeds ₹50,000.

• Immovable property received for not full consideration: If difference between stamp duty value and the amount of consideration is more than ₹50,000, such excess is taxable.

• Movable property taken without consideration: If the fair market value exceeds ₹50,000, full FMV is liable.

• Movable property taken for inadequate consideration – If the difference between FMV and consideration paid is over ₹50,000 then such diff. is taxed.

There are also exceptions which help protect legitimate commerce:

Gift bequests from close family members (spouse, parents, kids and lineal ascendants or descendants) are 100% exempt.

• By an individual in consideration of marriage of another Presents received –On the occasion of the marriage of an individual are exempt.

• Gifts received pursuant to a will, from an inheritance or from certain entities (such as trusts) are also not subject.

This would prevent abuse where people had previously made a gift of wealth to escape taxation. It seeks to ensure that gratuitous transfers not in consideration are recognized as income in the hands of recipients unless for real family or social reasons.

6.3.4 Allowable Deductions [Section 57]

While this head includes different kinds of income, only particular kinds of deductions from such income can be allowed in law. What can be deducted is detailed in Section 57 and it further ensures that only the genuine expenses which are specifically related to earning income are permissible.

The allowable deductions include:

• Commission or compensation for securing dividend or interest: If such charges are made by a banker on interest obtained upon securities, that expenses can be deducted.

• Family pension deduction: Family pension for legal heirs will be either one-third of the family pension or

₹15,000 as deduction if it is less.

• Borrowing cost: Where an assessee borrows money to invest in interest yielding asset (like fixed deposit) then the amount of loan is deductible from interest income.

• Any other expenditure, which is incurred wholly and exclusively to earn the income chargeable under this head: e.g. legal expenses incurred for recovery of a sum that is taxed under this head.

However, there are strict limitations:

• No deductions are permitted against profits and winnings earned through lotteries, races or gambling, etc., which is subject to gross tax.

• Personal expenses are strictly disallowed.

• Indirect costs which have no direct relationship to the generation of the income cannot be deducted.

Hence, by Section 57 deductions are restricted to the real cost, because it is the compromise between equity and the requirement not to allow abuse.

6.3.5 Taxability of Dividends, Interest, Lottery, etc.

There are a number of important kinds of earnings that typically fit into this category, and their tax status is deliberately aligned with what these earnings are actually accomplishing.

• Dividends: Taxable in the hands of shareholders at normal slab rates. Limited deductions are permitted, including interest paid on loans used to invest in shares, which cannot exceed 20% of dividend income.

• Interest: All income from bank deposits, loans, bonds and securities is subject to tax. TDS applies above certain thresholds. The exclusions are only in respect of specified saving instruments such as PPF.

• Prizes, betting and gambling: A flat 30 percent is taken off of lottery winnings, betting and gambling without allowing for deductions. Tax the Gross amount and Speculative/Windfall gains are rigidly taxed.

• Winnings from horse race: Like cash winnings it is also taxed at 30% with tax deduction as source.

• Miscellaneous incomes: Income from prizes, awards or lottery is taxable unless exempt under Section 10.

Such classifications are consistent with the legislative purpose to deal with various types of income according to the nature thereof. Normal incomes such as dividends and interest are taxed on a progressive basis, but windfall incomes are taxed at rigidly high rates to assure an enhanced yield.

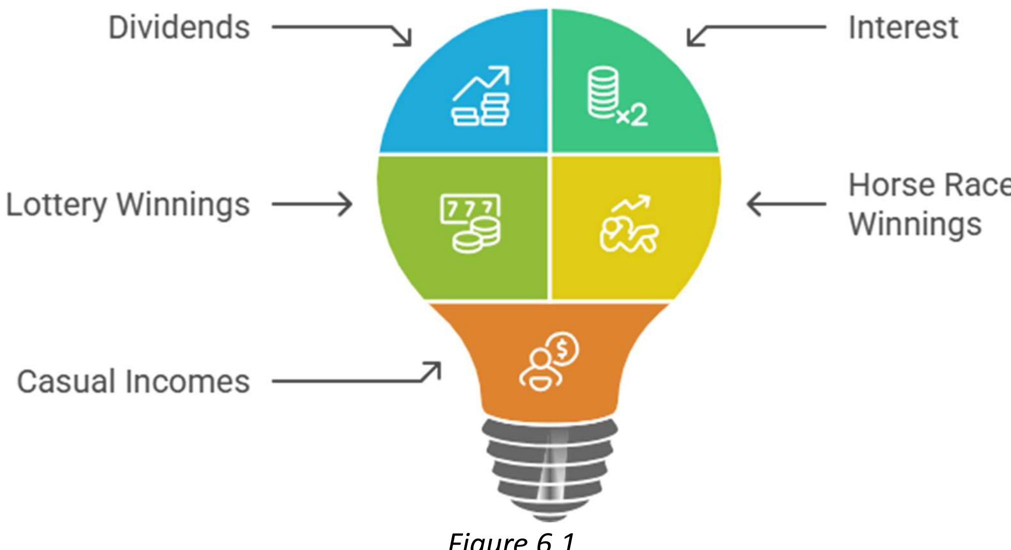

Figure 6.1

6.4 Summary

- Profits and Gains Le Case laws -109 from Business or Profession (PGBP) Taxability Chapter IV of the Act, Sections 28–44 involves organized and systematic commercial or professional activities.
- Deductible portions (Sections 30–37) consist of rent, repair saleries interest and bad debts while
- expenses not deductible (Sections 40 and 40A) would cover personal and income tax related expenses (but there could well be an overlapping with s40 disallowance provision), and an addition for payments that are in the nature of crime or illegality.
- Depreciation under Section 32 is calculated on the block of assets following reduction in WDV method at rates specified for type of asset.
- Presumptive basis of taxation (Sections 44AD, 44ADA, 44AE) ease the process of compliance for small businesses, professionals and transporters by providing them deemed income.
- Capital Gains (Section 45): It is a charge Income derived from transfer of capital assets, further according to the holding period capital gain is classified into Short term and Long term.
- Indexed cost of acquisition enables inflation indexation to long-term assets and the exemption under Section 54 i.e., 54, 54B, 54D and 54EC is for re-investment in house, agriculture land or infrastructure bond.
- Special provisions are in place for capital gains made on shares, securities, immovable property and depreciable assets to avoid under valuation of the asset and/or avoidance.
- Capital Gain is calculated by reducing the indexed cost and transfer related expenses from sale consideration at separate tax rates for STCG and LTCG.
- Income from Other Sources (Section 56) is a residuary head that includes all income not taxable under any other head, such as - interest, dividends, gift or prize etc.

- Section 56(2)(x) – Presumes gifts and income in certain cases Where there is transfer of assets for inadequate consideration without any or inadequate consideration: Gifts are taxed with few exceptions like relatives and celebrations.
- Deductions available under Section 57 are restricted to actual expenses such as collection charges, interest on borrowings and relief from family pension.
- Lottery, gambling and betting wins are subject to a final tax at 30% without any deduction or set- offs indicating the harsh treatment of casual as well as windfall incomes.

6.5 Key Terms

1. Capital Asset – Property of any kind held by the assessee, excluding stock-in-trade and personal effects (other than jewelry, etc.).
2. Depreciation —Allowance for depreciation in respect of tangible and intangible business assets as specified under S.32.
3. Presumptive Taxation – a scheme to allow small tax payers to declare their income at fixed rates based on turnover or receipts without maintaining books of accounts.
4. Short-term Capital Gain (STCG) – Income from selling short term assets (held for upto 24 or 36 months depending on the asset type).
5. LTCG – Capital Gain from assets sold after a period of time (the only capital gains eligible for Indexation & with lower tax rate)# c.
6. Indexed Cost- Inflation adjusted cost of purchase/improvement computed on the basis of the Cost Inflation Index.
7. Source: We should have seen dividend tax coming Dividend Income – Payment of dividends by a company to its shareholders currently being taxed in the hands of the recipient.
8. Gift Tax (Sec 56(2)(x)) – Money, property or assets received without consideration or with inadequate consideration of more than specified value is taxable.
9. Residual Income – Income other than that not covered under salary, house property, business/profession and capital gains chargeable to tax under the head “Other Sources”.
10. Pension Deduction for Family Members – In case of family pension received by legal heir : 1/3 of the pension or ₹15,000 w.e.f.
11. Windfall Tax – Unexpected income of an unearned nature such as lottery winnings, taxed only at a fixed rate with no deductions.
12. Block of Assets – Combination of business/business assets for which same rates of depreciation are prescribed under WDV method.

6.6 Descriptive Questions

1. Discuss the content of Profits and Gains from Business or Profession in Section 28.

2. Explain the charging section of business income with reference to the real income and accrual theories.
3. Compare short- term to long-term capital gains and provide some real life examples.
4. What are the deductions in Section 54 series for capital gain? Discuss in detail.
5. Discuss critically the taxation of gift and deemed income under section 56(2)(x).
6. Which deductions are allowed while computing income from other sources under Section 57?
7. Discuss the basis of charging dividend, lottery or gambling income under Section 56.
8. Jot down notes on the presumptive taxation sections 44AD, 44ADA and 44AE.

6.7 References

1. Income Tax Act, 1961 (Bare Act).
2. Income Tax Rules, 1962.
3. Singhania, V.K. Direct Taxes Law and Practice.
4. Ahuja, Girish, and Gupta, Ravi. Systematic Approach to Income Tax.
5. Chaturvedi, T.N., and Pithisaria, R.K. Income Tax Law.
6. Government of India, Ministry of Finance – Notifications and Circulars.

Answers to Knowledge Check

Knowledge Check 1

b) Sec 45

b) 24 months

a) Nil

a) Sec 54

b) 15%

6.4 Summary

- ❖ Profits and Gains Le Case laws -109 from Business or Profession (PGBP) Taxability Chapter IV of the Act, Sections 28–44 involves organized and systematic commercial or professional activities.
- ❖ Deductible portions (Sections 30–37) consist of rent, repair saleries interest and bad debts while
- ❖ expenses not deductible (Sections 40 and 40A) would cover personal and income tax related expenses (but there could well be an overlapping with s40 disallowance provision), and an addition for payments that are in the nature of crime or illegality.
- ❖ Depreciation under Section 32 is calculated on the block of assets following reduction in WDV method at rates specified for type of asset.
- ❖ Presumptive basis of taxation (Sections 44AD, 44ADA, 44AE) ease the process of compliance for small businesses, professionals and transporters by providing them deemed income.
- ❖ Capital Gains (Section 45): It is a charge Income derived from transfer of capital assets, further according to the holding period capital gain is classified into Short term and Long term.
- ❖ Indexed cost of acquisition enables inflation indexation to long-term assets and the exemption under Section 54 i.e., 54, 54B, 54D and 54EC is for re-investment in house, agriculture land or infrastructure bond.
- ❖ Special provisions are in place for capital gains made on shares, securities, immovable property and depreciable assets to avoid under valuation of the asset and/or avoidance.
- ❖ Capital Gain is calculated by reducing the indexed cost and transfer related expenses from sale consideration at separate tax rates for STCG and LTCG.
- ❖ Income from Other Sources (Section 56) is a residuary head that includes all income not taxable under any other head, such as - interest, dividends, gift or prize etc.
- ❖ Section 56(2)(x) – Presumes gifts and income in certain cases Where there is transfer of assets for inadequate consideration without any or inadequate consideration: Gifts are taxed with few exceptions like relatives and celebrations.
- ❖ Deductions available under Section 57 are restricted to actual expenses such as collection charges, interest on borrowings and relief from family pension.
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6. Government of India, Ministry of Finance – Notifications and Circulars.

Answers to Knowledge Check

Knowledge Check 1

b) Sec 45

b) 24 month

a) Nil

a) Sec 54

b) 15%

6.8 Case Study

"Taxation of Commerce, Capital and Other Income"

Mr. Rajiv, an individual resident, is a businessman dealing with property and shares. The financial year he sold:

His income from small sized retail business was ₹ 90,000.

Sale of residential house acquired in 2008 at ₹25,00,000. The sale amount was ₹90,00,000 and the stamp duty value was ₹95,00,000. He bought another house for ₹70,00,000 in the same year.

There was sale of equity shares listed on stock exchange which were held for 15 months, purchase consideration of ₹2,50,000 and the sales proceeds were as follows :— - Proceeds – ₹2,25,000 (Question No.

₹5,50,000.

Indian company paid you dividend of ₹ 1,20,000.

Interest on bank fixed deposit of ₹80,000.

Prize on account of lottery of ₹2,50,000.

(ii) A cash of ₹2,00,000 was presented to him by a family friend on his birthday.

Problem Statements

Problem 1: Computation and Taxation of Rajiv's Business Income?

Question 2: What are the tax implications (including exemption, if any) observing a capital gain arising on sale of the house and also on sale of listed equity shares?

Issue 3: Will I be taxed on dividend income, interest income, lottery winnings and gift under 'Income from Other Sources'?

Solutions

Solution 1: Business Income

The ₹9,00,000 Rajiv earned in the retail business will be charged to tax under the head Profits and Gains from Business or Profession. As the income is declarative and not under presumptive, it will be taxed on actual profit. Deductions under Subsections 30–37, if claimed, are not included here. Therefore, business income which is taxable = ₹9,00,000.

Solution 2: Capital Gains

• Residential house:

o Purchase value (2008) = ₹25,00,000.

o 1 April 2001 FMV can be replaced, but at the cost.

o Indexed Cost = 25,00,000 × (CII of year of sale / CII of 2008-09).

o If CII of 2008-09 is 137 and that of 2023-24 is 348 -> Indexed cost = â,¹25,00,000 × (348/137) ≈ ₹63,50,000.

o Actual consideration as full value = sale price and stamp duty value is ₹95,00,000.

o LTCG = 95,00,000 – 63,50,000 = ₹31,50,000.

o Exemption under Section 54: • Possibly Rajiv has acquired another residential house for Bible Research Organization Study Article General Information :Studies in the Scriptures Bible Students Sources-Fort Archives-Rick Friedrich-Hermann G. Bloomberg -Dekotha's.

₹70,00,000 exemption = lower of LTCG or cost of new house = ₹31,50,000.

o Net capital gain taxable = Zero.

• Listed equity shares:

o Holding > 12 months → Long-Term.

o Sale consideration = ₹5,50,000.

o Cost = ₹2,50,000.

o LTCG = ₹3,00,000.

o LTCG above ₹1,00,000 is taxed at 10% under section 112A.

o Taxable LTCG = ₹2,00,000.

Answer 3: Income from Different Heads of Income

• Dividend (₹1,20,000): Taxable in full under section 56(2)(i).

• Interest (₹80,000): Fully taxable under Section 56(2)(id).

• Lottery winnings (₹2,50,000): Flat 30% tax under Section 115BB with no deductions.

• Gift (₹ 2,00,000) : As the Gift is more than ₹50,000 and from relatives exemption of ₹ 2,00,000 will be offered under Section 56(2)(x).

So, income from other sources = 1,20,000 + 80,000 + 2,50,000 + 2,00,000 = ₹6,50,000.

Reflective Questions

Explain section 54, how it promotes the investment of capital gains and what is its social objective?

Should lottery and windfall taxes be higher than normal tax? Why or why not?

Do you appreciate the fairness of levying tax on gifts under Section 56(2)(x) taking into account Indian customs for giving gifts?

How does the concept of indexation act as a leveler for taxation on long term assets?

Could presumptive taxation have been better for Rajiv's retail business? Discuss.

Conclusion

This case demonstrates how several sources of income present for a taxpayer. That Rajiv's income was comprised of business profits, exempted long-term gains from property, concessional taxation on equity shares and harsh taxation of casual incomes. Exemptions, indexation and flat-rate taxation illustrate the complexity and comprehensiveness of the Income Tax Act. The case illustrates the significance of tax planning, maintaining documentation and knowledge of provisions to maximize compliance and minimize potential liability within the boundaries of the law.

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Unit 7 Deductions under Chapter VI-A & Computation of Total Income

Learning Objectives

1. Understand the scope and importance of Chapter VI-A deductions in reducing taxable income under the Income Tax Act.
2. Identify the key sections of Chapter VI-A, such as deductions available under sections 80C to 80U.
3. Explain the eligibility conditions, limits, and nature of expenditures or investments qualifying for deductions.
4. Distinguish between deductions allowed to individuals, Hindu Undivided Families (HUFs), and other taxpayers.
5. Apply the step-by-step process of computing Gross Total Income (GTI) and thereafter applying Chapter VI- A deductions.
6. Analyze the effect of deductions on taxable income and the ultimate tax liability of the assessee.
7. Develop the ability to compute total income of an assessee by systematically considering all sources of income, set-off rules, and deductions.

Content

7.0 Introductory Caselet
7.1 Gross Total Income and Taxable Income
7.2 Deductions under Chapter VI-A (Sec 80C to 80U)
7.3 Tax Rebates and Exemptions
7.4 Tax Slabs and Regimes for Individuals
7.5 Summary
7.6 Key Terms
7.7 Descriptive Questions
7.8 References
7.9 Case Study

7.0 Introductory Caselet

Mr. Rajesh, 35, is a project manager for a prominent IT company in Bengaluru. His gross salary per annum is ₹12,00,000. Apart from this he receives interest income of ₹50,000 on FDs. Making his Gross Total Income (GTI) ₹12,50,000 before any deductions under Chapter VI-A.

As a middle class tax payer, Rajesh wants to reduce his tax liability as much as possible by taking all the legal deductions. His tax saving in the financial year shall be as follows:

Investments & Savings (Section 80C):

oPPF : Maximum:(Contribution to PPF ₹1,20,000)

o Premium on life insurance for self and spouse: ₹30,000

o Total claimed under 80C: ₹1,50,000 (maximum limit eligible for).

Health Insurance Premium (Section 80D):

o Premium on self and spouse: ₹20,000

o Premium for parents (Senior citizens) : ₹30,000

o Aggregate claimed under Section 80D: ₹50,000 (upto limits).

Donation to Charity (Section 80G):

o Donation to a registered charitable trust: ₹15,000

o Eligible deduction: 50% of donation = ₹7,500 Tax Computation Snapshot that ……………………

• Gross Total Income (GTI): ₹12,50,000

• Less: Deductions under Chapter VI-A

o Section 80C: ₹1,50,000

o Section 80D: ₹50,000

o Section 80G: ₹7,500

o Total Deductions: ₹2,07,500

• Total Income (Taxable Income): ₹10,42,500

Via these deductions and exemptions, his taxable income is now lower by more than ₹2 lakhs, and the tax saving is fantastic.

The Dilemma

Though Rajesh finds a fair amount of satisfaction in saving on his taxes and making long-term investments, a colleague suggests him to remember not go completely overboard with it.

Rajesh is possibly tying up a large sum in tax saving channels like PPF and insurance, thus impacting his investment flexibility and short-term liquidity. And mindless investing, simply to make sure I was hitting the maximum deduction limits didn't necessarily gel with his other financial aspirations such as buying a house, saving for one of his children's education or establishing an emergency fund.

Critical Thinking Question

Rajesh He has been able to efficiently leverage the deductions available under Chapter VI-A and lower his tax liability. But is tax planning always about getting the biggest possible deduction, or should it be part of a holistic financial plan that addresses wider concerns like liquidity, risk management and future dreams? Discuss your viewpoint with justification.

7.1 Gross Total Income and Taxable Income

GTI includes the sum of income calculated under all five heads of income, excluding the deductions under Chapter VI-A. Taxable Income is calculated by subtracting allowable deductions from GTI. By this procedural mechanism, the final tax liability of an assessee is computed in a fair, transparent and just manner.

7.1.1 Definition of Gross Total Income (GTI)

Gross Total Income (GTI) is the combined income generated by an assessee in a financial year from varies sources, computed under the acquiescence of the Income Tax Act, 1961. With regards to what is central to the concept of income, it is not just a total of receipts but one that has furnishing revenue as its legal meaning--looking out for fairness and efficiency in taxation. GTI is the basis on which Total Income or Taxable Income that you are to pay tax is calculated.

The Income Tax Act categorizes income under five heads and GTI brings them together after adjusting for allowed setoffs. These heads are:

• Salaried Income: Wages, pensions, allowances, bonus, commission and perquisites are covered under this head.

• House Property Income: Includes income from owned property let-out or rented.

• Profits and Gains of Business or Profession: It covers the income from business or profession.

• Capital Gains: Profits received on sale/transfer of capital assets such as property, shares or security.

• Income from Other Sources: A category of income that is left after including all other types such as interest, dividend, gift and winnings.

GTI is calculated after clubbing of income and set-off of losses but before the deductions under Chapter VI-A. For instance, if an Assessee 1 has the salary income worth ₹8,00,000 and house property loss of

1,00,000/- and the income from capital gains would be ₹2,00,000 then GTI will be = ₹9, 0 lacs but it's subjected to adjustment.

Features of GTI:

• Comprehensive concept: GTI covers income from every source which was taxable under the Act.

• Pre-deduction: Deductions like those under Section 80C are not applicable before you reach at GTI.

• Clubbing : Income of spouse/minor child, as applicable is aggregated in GTI.

• Exemption from Exempt incomes: Agricultural income and Section 10 exemptions are not included in GTI.

GTI is used for clubbing together different income sources, and it gives complete picture of taxpayer’s ability to pay tax and therefore it is an important step in calculation of tax.

7.1.2 Steps to Compute GTI from All Five Heads

The calculation of GTI is incremental in nature because all the heads of income are first computed as per their rules and added to derive the GTI. This prevents overlapping and gives greater uniformity.

The steps are:

Income from Salaries:

o Commence with the gross salary – basic, dearness allowance and the perks.

o Minus qualifying deductions under Section 10 like HRA.

o Deduct standard deduction of ₹50,000 (on Salary Income) .

o The result is taxable salary.

Income from House Property:

o Calculate Gross Annual Value (GAV) i.e., higher of Expected Rent or Rent Received.

o Deduct municipal taxes actually paid.

Apply 30% standard deduction on Net Annual Value.

o Deduction of interest on housing loan under section 24(b).

o Balance is house property income/loss.

Profits and Gains Of Business or Profession:

o Start with the profits as shown by Profit and Loss Account.

o Include and disallowed deductions such as penalties, donations & income tax etc.

o Remove expenses that are allowable but not booked in books for example, some reserves.

o Think of Depreciation income tax act not Company's Act.

o Arrive at taxable business income.

Capital Gains:

o Determine whether the gain is long-term or short-termed based on how long you held it.

o Take on the cost of acquisition, improvement and transfer.

o For long-term assets, index cost.

o Subtract exemptions under Sections 54, 54EC, 54F, where such proceeds are re-invested.

o Arrive at net capital gains.

Income from Other Sources:

o Have Incomes which do not belong to any other head, like dividends, awards or incidental incomes.

o Charge legitimate expenses, such as collection costs on dividends.

o Arrive at the net income from another source.

Aggregate and Adjust:

o Take the summation of all five heads.

o Account for intra-head and inter-head loss setoffs.

o It will result in Gross Total Income.

This one-by-one process allows for no income to be overlooked and loss adjustments will be taken into account in a legal manner.

Figure 7.1

7.1.3 Adjustments for Set-off and Carry Forward of Losses

All sources of income do not produce profits each year as there are also weaknesses sometimes. The Income Tax Act permits taxpayers to offset these losses against income in order to arrive at a fair calculation.

Types of Adjustments:

• Intra-headset-off: Deduction under one head for loss from a source can be adjusted with income from another source within the same head.

o For Instance, Losses from one house property can be adjusted against income from another house property.

• Inter-headset-off: If inter-head adjustment remains but still with loss, it can also be set off against income under another head (subject to certain conditions).

o Example: You can set off the losses on house property (to maximum limit of ₹2 lakh) against salary income.

•Carry Forward of Losses: Losses which cannot be set off in the year can be carried forward to the future years. Disclaimer (B) in case of timely return and disclosure Certain conditions, including filing of returns on time, are to be continued for the claim's validity.

Rules for Carry Forward:

- Losses from house property: forwarded for 8 years and set off against house property only.
- Business loss: Can be carried forward for 8 years and set off only against business income.
- Business loss (other than speculation): Carry forward 4 years, set-off only against speculation income.

• Capital loss:

o STCL is adjustable against both STCG and LTCG.

o LTCL only against LTCG.

• Loss by racehorses: forward 4 years, set off against only such income.

These provisions are also fair because tax is conceptually based on the ability to pay over time and does not punish taxpayers for short-term reversals.

7.1.4 Deductions from GTI to Arrive at Total Taxable Income

The MCR is the Medicare levy rate, as defined in para 7.2.6, which multiplied by TTMI gives us reduced amount for this purpose:= x o c Where: MCR IS DEFINED IN PARA 7~2"e>.

After GTI has been calculated, deductions under Chapter VI-A are applied to arrive at Total Income/ Taxable Income. This latter condition is not just true for the relief it offers to taxpayers, but also because it promotes socially and economically attractive expenditure.

Major Categories of Deductions:

• Section 80C: Up to Rs.1,50,000 towards investments like PPF, life insurance premium, ELSS, tuition fees and housing loan principal repayment.

• Section 80CCC & 80CCD: Investment in pension funds and National Pension Scheme also comes under this section with an additional deduction of ₹50,000 in NPS under section 80CCD(1B).

• Section 80D: Health insurance premiums, with enhanced limit in case of senior citizens.

• Section 80E: Interest on education loan, available for maximum of 8 years.

• 80G: For donations to institutes, where 100% or 50% of the amount donated is deductible (depending on the fund).

• Section 80TTA and 80TTB: Deduction on savings account interest (up to ₹10,000 for non-senior citizens, up to ₹50,000 for senior citizens) You are eligible for deduction of a maximum of ₹10,000 as income tax saving due to the bank interest paid on the balance (savings account).

₹50,000 for seniors).

• Section 80U: Certain fixed deductions that are available to people with disabilities.

Importance of Deductions:

• Relief by reducing taxable income:

• Encourage taxpayers to save in long-term financial products.

• ["Help the needy with] public charity and health care.

It is therefore GTI less deductions which provides the final amount on which tax is to be charged.

7.1.5 Format of Computation with Illustrative Examples

For consistency, the same algorithm is used in calculating GTI and taxable income. This layout is more straightforward and reduces the complexity of errors.

Format:

Income from Salaries

Income from House Property

Business/Profession Income

Capital Gains

Income from Other Sources

Gross Total Income (sum of the above after loss adjustment)

Less: Deductions under Chapter VI-A

Total Income (Taxable Income)

Illustration:

Suppose Mr. A has:

• Salary: ₹6,00,000

• House property loss: ₹1,00,000

• Business income: ₹2,50,000

• LTCG: ₹2,00,000

• Interest income: ₹50,000

Computation:

• Salary: ₹6,00,000

• House property: (₹1,00,000)

• Business: ₹2,50,000

• Capital gains: ₹2,00,000

• Interest: ₹50,000

• GTI = ₹10,00,000

Less: Deductions under Chapter VI-A:

• 80C: ₹1,50,000

• 80D: ₹25,000

• Total Deductions = ₹1,75,000

Taxable Income = ₹8,25,000

The following example represents the process of computation of taxable income from various heads of income in an orderly manner.

“Activity: Practical Computation of GTI and Taxable”

Ravi earns a salary of ₹9,00,000 and income from house property ₹60,000 (after deductions). He has a business income of ₹1,20,000 and interest income of ₹40,000. During the year, he invests ₹1,20,000 in ELSS, pays ₹30,000 health insurance premium, and donates ₹20,000 to an eligible fund. Compute his GTI and Total Income, and evaluate whether he has optimized his deductions effectively. Discuss the importance of balancing tax savings with liquidity.

7.2 Deductions under Chapter VI-A (Section 80C to 80U)

Chapter VI-A of the Income Tax Act lists out various deductions which can be claimed by a taxpayer to reduce his Gross Total Income. Encompassing Sections 80C to 80U, it encourages savings and investments in insurance, health care, education and charity besides covering the social aspects of disability etc.

7.2.1 Overview of Chapter VI-A Structure

Broadly speaking, Section 80 of the Income Tax Act, 1961 is one of the most exhaustive baskets which constitute Indian tax laws that are related to some deductions allowed from Gross Total Income. These are not exemptions but specific amounts allowed to be deducted from GTI, in order that the final tax liability will reflect net liability after making socially relevant and economically important contributions. The sections range from 80C to 80U and include several tax-saving routes like investments, insurance, health care expenditure, donations, education expenses and social security among others.

Chapter VI-A has been laid down for two reasons. One is it motivates people to save and invest in government-approved financial products such as PPF, NSC or ELSS. Second, it can be built a wider social base of supporters married people including other tax relief on things like health insurance premiums, education loans or gifts to charity.

Classifications of Deductions under Chapter VI-A

For comprehension purposes, these deductions may be loosely categorized as:

•Savings-based deductions: Such are Section 80C, 80CCC and 80CCD work to encourage savings, pension and NPS contributions.

• Deductions on health: 80D for medical insurance, and 80DDB for treatment of diseases.

•Social welfare deductions: Sections like 80E, which provides for education loans, and 80U, for people with disabilities.

• Other philanthropy-related deductions: Section 80G promotes contributions to charitable trusts, funds and relief funds.

• Income-based deductions: With the view of providing some relief on interest income, for small savers and senior citizens Section 80TTA and 80TTB respectively have been introduced.

The idea is to bring tax policy in line with long-term financial planning, incentivizing behavior that is good for individuals and society. For instance, where Section 80C subtly influences people towards disciplined investment, Section 80D popularises healthcare awareness and Section 80G inspires you to give to charity.

Key Characteristics:

•Tax write offs must be substantiated with proper documentation.

• Aggregate limit applicable is 51 (such as ₹1,50,000 u/s 80C,80CCC and 80CCD(1)).

• Some deductions such as 80D and 80G have their own limits in addition to those imposed under Section 80C.

• Some deductions, such as 80U, are limit independent of the actual expense.

So Chapter VI-A itself is a system of deductions to income tax, in which an individual gets relief and also indirectly puts back money into the economy and society.

7.2.2 Sec 80C: LIC, PPF, NSC, ELSS, Tuition Fees and so on

2kg deduction under Chapter VI-A of the Act is probably

except, ₹1,50,000 with respect to certain other investments) It is applicable on individuals and Hindu Undivided Families (HUFs) however it does not apply to companies, firms and LLPs.

Investment and Payment on which deduction is allowed under Section 80C:

• Life Insurance Premium (LIC): Payment of premium on policies issued by Life Insurance Corporation in the name of self, spouse or any child of such individual. For HUFs, the life insured can be any of the adult members.

• Public Provident Fund (PPF): You can claim deductions on contributions to PPF accounts held by self, spouse or children. It provides tax-free returns and maturity.

• National Savings Certificate (NSC): Investment in NSC, can be claimed for deduction and interest accrued thereon, is also claimable in future year as reinvestment.

• ELSS (Equity Linked Savings Scheme): A mutual fund scheme with a lock-in of 3 years, which provides market linked returns along with tax benefits.

• Tuition Fees: Tuition fees paid for up to 2 children in a academic year for study in India.

• Repayment of Housing Loan Principal: The principal amount paid against the repayment of loan borrowed from banks or housing finance companies.

• Other Contributions: Senior Citizens' Savings Scheme, 5-year tax saving fixed deposits and Sukanya Samriddhi Yojana too are eligible.

Conditions and Restrictions:

• The aggregate of deduction u/s 80C is limited to ₹1,50,000/- in a financial year.

• If you wish to exit/ surrender the investment before the specified time period, it may result in deduction claimed being reversed.

• Contributions have to be made from taxable income in order to qualify.

Importance of Section 80C:

• Encourages long-term financial discipline by driving people toward savings and investments.

Supports Government Schemes like PPF and Sukanya Samriddhi for social-good.

• It's flexible, for covering the broad range of financial products.

"Section 80C is the backbone of individual tax planning in India, and has a pervasive impact on personal finance decisions.

7.2.3 Sec 80D: Medical Insurance

Section 80D - to promote health awareness Section 80D benefits you for the amount paid in premiums related to medical insurance policy and preventive health check-ups. While 80C is investment-centric, 80D becomes the year centric and gives a fillip to health protection.

Eligible Expenses under Section 80D:

• Medical insurance premiums: Premiums paid (including payments made by the employee) for a medical insurance policy which includes cover in respect of self, spouse, dependent children & parents.

• Preventive Health Check-up: An amount equal to 1% of the Sum Insured is payable as preventive health check-up benefit.

• Central Government Health Scheme (CGHS): Deductions towards CGHS payments are deductible.

Limits of Deduction:

• ₹25,000 towards premiums paid for self, spouse and dependent children.

• Another ₹25,000 for premiums paid for parents (₹50,000 if parents are senior citizens).

•If taxpayer as well as parents are senior citizens, then maximum deduction can go up to ₹1,00,000.

Specific Rules:

• You need to pay through any other mode than cash to be eligible, excluding preventive health check-ups.

• Deduction even available if premium is paid for non dependent parents.

• Policies should be issued only by the IRDAI-approved insurers.

Broader Significance:

• Encourages financial planning from increasing medical expenses.

• Motivates younger taxpayers to purchase health insurance at an early age."

• Relieves the financial pain of a medical emergency.

So, when it comes to health security and saving on taxes together then Section 80D there ensures that one considers healthcare as important part of their financial planning.

7.2.4 Sec 80G: Donations

Donations to a notified fund, eligible institution or for charitable purposes introduced Section 80G which offered tax deductions in respect of donations. It's a way to acknowledge and reward the taxpayer's role in promoting social welfare and nation-building.

Eligible Donations:

• Contributions to the Prime Minister's National Relief Fund, PM CARES Fund, National Children's Fund and other notified funds; establishments or institutions; or organizations as may be prescribed, in item (vi) at SN 1(ii).

• Donations to universities, hospitals and charitable trusts approved by the Government.

• Donations for renovation or repair of sthanaks, cemeteries, notified temples, masjids, gurdwaras and churches.

Categories of Deduction:

100% Deduction without Any Limit: Donations to National Defence Fund, PM CARES Fund ETC.

50% Unlimited Deduction: Some unique notified funds are eligible.

100% of the Deduction (limited to 10% of GTI): For amounts paid as Donation to Government-approved Schemes.

50% Deduction subject to 10% of GTI : Most other recognized charitable trusts comes here.

Key Considerations:

• Contribution shall be in the form of cheque/draft/Digital Mode. Cash donations in excess of ₹2,000 are not eligible.

• Donations to only registered organization, that have valid approval are eligible.

• Donor should get receipt of donation indicating PAN and registration number of institution.

Importance:

• Offers a financial incentive for donations to charity.

• Makes possible for resources to be mobilised for service of the welfare. ◦ Mayabhai temple with asylum stacks for sick pilgrims at Mount Abu. ◦ Asylum said otherwise under Hundi are personal welfare activity, not a religious activities.

• Promotes corporate social responsibility in personal development programmes.

Section 80G, therefore formalizes the philanthropic culture and attaches it with a direct tax incentive.

7.2.5 Other Notable Sections: 80E (Education Loan), 80TTA/TTB (Interest), 80U (Disability)

There are a number of other provisions in Chapter VI-A that cater to the diverse requirements and contingencies, making for holistic tax relief.

Section 80E: Education Loan Interest

• Deduction for the interest paid on education loan taken for higher studies in India or outside India.

• Loan should be taken from a financial institution or charitable trust.

• The deduction is for 8 years or until the interest is paid, if earlier.

• Covering education cost of yourself, spouse, children and student who is the assessee’s ward.

Section 80TTA and Section 80TTB: Deduction on Interest Income

• Section 80TTA: Deduction for interest on savings bank account, post office savings or deposits in cooperative society to the extent of ₹10,000. Applicable only for Individual and HUF (non-senior citizen category).

• Section 80TTB: This is senior citizen exclusive and it permits a deduction of ₹50,000 for interest on all types of deposits (including fixed & recurring deposits).

Section 80U Deduction for Persons suffering from Disabilities

• Standard deduction for resident individuals with disabilities which is irrespective of actually incurring expenditure.

• ₹75,000 for individuals with 40% or more of the disability.

•₹1,25,000 in case of severe disability (80% or more).

• Can be issued only by a qualified medical authority.

Broader Impact:

• Encourages education by reducing the cost of loans.

• The budget will also provide support to small savers and senior citizens on the back of inflation and low returns.

• Gives immediate relief to the disabled and lessens their financial burden.

Did You Know?

"The deduction under Section 80U is fixed, meaning it does not depend on how much the taxpayer spends on disability-related expenses. Even if no money is actually spent, the taxpayer with a certified disability is still entitled to claim the full deduction allowed under the section."

7.3 Tax Rebates and Exemptions

Tax rebate and exemption are vital elements under the Income Tax Act which brings down tax liability of an assessee. Though rebates reduce the amount of tax that is payable, exemptions exclude specific sources of income from the tax net. A knowledge of these provisions is necessary for convenient tax planning and the correct calculation of liability.

7.3.1 Sec 87A: Rebate for Resident Individuals

Rebate under section 87A of Income-tax Act Section 87A gives relief from payment of tax to an individual who is a resident in India (Basic Exemption Limit) and whose total income does not exceed Rs. This rebate was brought in to give relief to the lower and middle- income group taxpayers as they pay same amount of tax even if their income is not growing.

Under the old tax regime, the provision provides for a rebate where such resident's total income (after claiming deductions under Chapter VI-A) does not exceed ₹5,00,000 – before giving effect to provisions of section 87A i.e., rebate. In these cases, the rate is a maximum of ₹12,500 or actual tax payable, whichever is lower. This means those having a taxable income of upto ₹5,00,000 do not have to pay any income tax.

With the advent of the new tax regime (Section 115BAC) a higher income is now covered by Rebate Limit. In terms of the amended rules, where resident individual has taxable income up to ₹7,00,000 he shall be entitled for a rebate under Section 87A so that there would be no tax liability in such cases.

Key Conditions:

• Only for resident individuals (not non-residents, HUF, firms or companies).

• Calculated after reduction but before cess.

• The figure is limited to actual tax due; it cannot exceed that amount.

• After income surpasses the threshold (₹5,00,000 for old regime and ₹7,00,000 for new regime), rebate is eliminated completely.

Importance of Section 87A:

• Protects low and middle-income taxpayers.

• Eases off on compliance for those below The Threshold.

• Provides relief on the intake of new tax regime maintaining higher rebates.

As such, Section 87A is a potent measure of relief which serves to maintain equity as well as progressivity in the Indian tax structure.

7.3.2 Exemptions vs Deductions: Key Differences

Tax exemptions and deductions are often misunderstood as having the same purpose. Both lessen the amount of income on which one pays tax, but they are dissimilar in terms of range, application and qualification.

Exemptions

Exemptions exempt some categories of income from Taxation altogether. This income is not included in the Gross Total Income. To name a few, income from agriculture, allowances and receipts specified under section 10.

Deductions

Deductions are the subtractions of reduced from Gross Total Income to arrive at the total income of an individual. They are deductions permitted under Chapter VI-A for certain investments, payments, or contributions: PPF contributions, health insurance premiums, donations etc.

Differences between Exemptions and Deductions:

• Nature: The exemptions do not include income, deductions against GTI.

• Point of Application: Exemptions are before GTI, deductions are after.

• For example: You can exempt agricultural income, HRA, gratuity and claim tax deductions under Section 80C, 80D, 80G among others.

• Flexibility: Exemptions are often automatic if the criteria is satisfied, while deductions involve some real spending or investment.

Points of Significance:

• Benefits to exemptions are greater because the income is never included in the first place.

• Deductions incentivize socially good behavior, including saving and insurance.

• Tax planning typically includes a balancing of exemptions and deductions to minimize liability.

So are intended to reduce tax liabilities, but there is a difference: Exemptions and deductions Exemptions are automatic reliefs provided for by the system, while deductions depend on your action as a taxpayer.

7.3.3 Agricultural Income Treatment (Partial Integration)

Income from agriculture is usually exempted from tax u/s 10(1). But sometimes, use is made of the principle of partial integration. The objective is to avoid the abuse of exemption whereby taxpayers with substantial non-agri income disproportionately gain.

How Partial Integration Works:

Combine agriculture income with non-agriculture income.

Calculate the tax on the total income.

The tax calculated on agricultural income plus the basic exemption limit shall be deducted.

The remainder is the net tax due.

This way, the principle of progression is being secured by incorporating agrarian income in reckoning rate even if it is not taxed.

Applicability:

• However, applicable only if non-agricultural income is more than basic exemption limit.

• 1Not applicable when agricultural income is less than ₹5,000.

• Applicable to : All individuals, HUFs/AOP/BOI and AOJ.

Example:

A person with ₹4,00,000 non-agricultural income and ₹3,00,000 in agricultural income will see the agricultural income (exempt though otherwise) included to an extent for rate computation by way of partial integration.

Significance:

• Prevents misuse of agricultural exemption.

• Shields small farmers as exemption is absolute for lower earnings.

• Equalizes the tax burdens of taxpayers with like ability to pay.

This is how agricultural income is exempted but closely regulated under the system of partial integration to split the difference between fairness and revenue.

7.3.4 Income Not Forming Part of Total Income (Sec 10)

Section 10 of the Income Tax Act, specifies certain incomes that are exempted from tax and do not become part of total income. These rules are designed to remove from the definition of income, receipts that are either socially attractive, economically sensitive, or administratively decent.

Significant Incomes Exempt Under 10 Section :

• Income from Agriculture [Sec 10(1)]: Completely Exempt, except for partial integration.

• Leave Travel Allowance [Sec 10(5)]: Leave travel concession which has been incurred for employee and his family on leave to any place in India.

• House Rent Allowance [Sec 10(13A)]: Exempt subject to limits if any prescribed based on salary & rent paid.

• Gratuity [Sec 10(10)]: Exemption is based on limits permitted under Payment of Gratuity Act or certain specified amounts.

• Commuted Pension [Sec 10(10A)]: Partly exempt if in Govt. Jobs.

• Scholarships [Sec 10(16)]: Fully exempt.

• Dividends from Indian Companies [Sec 10(34)]: Exempt subject to provisions of dividend tax.

• Political Parties' Income [Sec 10(23B]: Exempt provided conditions satisfied.

Characteristics of Exemptions Referred in Section 10:

• Accumulate automatically if requirements are met.

• Meant to aid workers, students, farmers and charities.

• Some are partial exemptions, some are full.

The scale of exceptions indicate a government's desire to back particular activities and individuals at the same time as balancing the books.

7.3.5 Common Exemptions: HRA, LTA, Gratuity, etc.

With the exception of s 10 in its entirety, some exemptions are particularly prevalent in practice, and this is notably the case for salaried workers.

House Rent Allowance (HRA)

Exemption is available u/s 10(13A) to employees in respect of house rent allowance. One of the following is not to be included:

• Actual HRA received.

• 50 per cent of salary (metro cities) or 40 per cent (non-metros).

• Rent paid less 10% of earnings.

Leave Travel Allowance (LTA)

Exempt under Section 10(5) for expenses incurred for such journeys in India. Two trips in any four-year block. Travel only is covered, not hotel or other expenses.

Gratuity

Exempt from Section 10(10), but subject to the following conditions:

• For government employees: fully exempt.

• To others: tax-exempt to an extent of ₹20 lakhs (as per the Gratuity act regulations).

Other Common Exemptions:

• Reduced Favorable Pension: Exempt until 50% depending on type of job.

• Voluntary Retirement Compensation: Not applicable up to ₹5 lakhs as per Section 10(10C).

• Retrenchment Package: Free up to the prescribed limits.

These are everyday basic exemptions which constitute the limbs of the reliefs available for salaried individual with a substantial erosion in their taxable income.

Knowledge Check 1

Choose the correct options:

Q1. Section 87A rebate is available only to:

a) HUFs

b) Non-residents

c) Resident individuals

d) Companies

Q2. Exemptions apply before:

a) Deductions

b) Rebates

c) Surcharge

d) Filing

Q3. Agricultural income is subject to:

a) Full tax

b) Partial integration

c) Standard deduction

d) No adjustment

Q4. HRA exemption depends on:

a) Gross salary

b) Actual HRA

c) Rent paid

d) All of these

Q5. LTA exemption covers:

a) Airfare only

b) Travel expenses within India

c) Hotel bills

d) Meals outside India

7.4 Tax Slabs and Regimes for Individuals

They refer to the structure of tax slabs for individuals under which personal tax liability is determined. The Indian system offers two options: the old regime that permits deductions and exemptions, and new under Section 115BAC featuring lower rates while reducing deductions. The decision-making weight of the regime selection is based on tax efficiency.

7.4.1 Old Regime: Slabs and Deductions Allowed

The old tax system is the conventional method of paying taxes on income in India. It is constructed on a graduated slab basis, so that for those with higher incomes each stack of income is taxed at increasing rates. This scheme has always been the basis of individual taxation in India and is still open to tax payer's choice.

Old Regime (for person below 60 years) Slab Rates

• Income (not exceeding ₹2,50,000) – Nil

• Income between ₹2,50,001 to ₹5,00,000 – 5%

• Between ₹5,00,001 to ₹10,00,000 – 20%

• Income above ₹10,00,000 – 30%

Senior citizens (aged 60 years or above but less than 80 years) The basic exemption limit for senior citizens is ₹3,00,000. This limit for very senior citizens (over 80 years of age) is higher at ₹5,00,000.

Deductions and Exemptions Allowed

One of the biggest pluses of the old regime is that there are scores of exemptions and deductions, which can bring down your taxable income significantly. Some of the key ones include:

• 80C: Maximum deduction of ₹1,50,000 that includes contribution to anything including PPF, NSC and ELSS, school fees (for up to two children), life insurance premium etc.

• Section 80D: For deduction of medical insurance premium.

• Section 80E, 80G, 80TTA/TTB: Education loan interest; donations; and interest on savings.

• House Rent Allowance (HRA): For salaried people who live in rented house.

• LTA (Leave Travel Allowance): Tax free for travel inside India.

• Tips, Pension Commuted, Voluntary Retirement Compensations: As per Section 10.

Advantages of Old Regime

• Promotes savings and investment with the help of tax-saving measures.

• Offers relief to families through deductions such as HRA and tuition fees.

• The elderly get higher exemptions.

Limitations

• Complicated by multiple deductions and exemptions.

• Not good for people who have limited investments and expenses.

• higher nominal rates when compared to the new framework.

In this way, the old regime provides relief through deductions, but also demands careful execution of tax planning and rigorous documentation.

7.4.2 New Regime (Sec 115BAC): Lower Rates, No Deductions

Budget 2020 brought in the new tax regime under Section 115BAC which aimed to simplify personal taxation by offering lower slab rates and doing away with most deductions and exemptions. It's a reversal going from an incentive to invest, to just plain taxation.

; Stone II, supra (holding § 4 of the Clayton Act unconstitutional as violative of the separation-of-powers doctrine).

• Upto ₹3,00,000 – No tax

• 5% from ₹3,00,001 to ₹6,00,000 of income

1 • 6,00,001 to INR 9,00,000 – 10%

• INCOME FROM ₹9,00,001 TO ₹12,00,000 – 15%

• Income between ₹12,00,001 and ₹15,00,000 – 20%

• Income above ₹15,00,000 – 30%

Further, the rebate u/s 87A takes care of persons having taxable income up to ₹7,00,000 in this regime not paying any tax.

Main Characteristics of the New Regime

• Negligible Deductions: Most deductions and exemptions like HRA, LTA, 80C etc have been taken away.

• Standard Deduction: The standard deduction for Salaried employees and Pensioners is ₹50,000.

• Levy and Cess: Levy and cess as per the law of land.

• Optional: Taxpayers may opt for the old or the new regime every year (for those without business income).

Advantages

• Reduced tax rates in each of the income brackets.

• Easy to comply and no more bulky documents.

• Suitable for those who do not invest much for availing tax benefits.

Limitations

• Inappropriate for taxpayers with significant deductions.

• *May not encourage savings/ investments in long-term instruments such as PPF or insurance.

• No deduction on housing loan interest or children's tuition fees.

So the new rules are much simpler but perhaps not always the most tax-efficient, depending on individual circumstances.

7.4.3 Comparison Between Old and New Regimes

Taxpayers should compare the two systems to see which will result in greater tax savings when faced with a decision between old and new regime.

Differences in Structure

• Rates: More slabs with lower rates for new regime, fewer slabs but higher rates for old regime.

• Deductions: Old regime has plentiful deductions; new regime has barely any.

• Exemptions: HRA, LTA and allowances covered under old regime; new regime excludes most.

• Flexibility: Taxpayers can change annually if they don't have any business income; otherwise the choice is limited.

Suitable Profiles for Old Regime

• Salaried employee with large deductions (80C, 80D, HRA, LTA).

• Highly education- or health-expense families.

• Long term savers and those in need of life insurance.

Suitable Profiles for New Regime

• Young professionals with minimal investments.

• Tax payers who want high liquidity and do not want to block the money in tax saving instruments.

• For those who have deduction of total below ₹2,50,001 per annum.

Analytical Example

For someone who has an income of ₹12,00,000 and deductions amounting to ₹3,00,000 the old regime may translate into lesser tax outgo. But, if the amount of deductions is basic (₹50,000), then the new regime can be more advantageous.

Therefore, the contrast will always be unique depending on your earnings, write-off and financial targets.

7.4.4 Who Should Opt for Which Regime? Factors to Consider

There are several personal and financial factors to consider when selecting between regimes. It is not a simple one-size-fits-all decision.

Factors Influencing the Choice

• Quantum of Deductions: Those who are able to enjoy deductions above ₹2,50,000, should continue with the old regime.

• Employment status: Salaried people earning HRA or LTA exemption may find the old regime better.

• Age, Family and Stage: Young singles with no large expenses may like the new regime; families may prefer old.

• Investment Habits: People who usually invest in such tax-saving schemes as PPF or insurance get more from the old regime.

• Liquidity Requirement: New regime is appropriate for people who like to enjoy immediate cash flow without any forced savings.

• Stable Income: People with fluctuating income may find the new regime more convenient.

Practical Guidelines

• Figure out tax liability under both systems before filing returns.

• Think long-term instead of here and now.

• Mix and match Section 87A rebate benefits from both regimes to maximise.

As such, the choice of regime should be determined by not only short term tax savings but also overall financial planning objectives.

7.4.5 Examples of Tax Calculation Under Both Regimes

It is instructive to study practical examples in other to know the effects of both orders.

Example 1: Person with Zero Major Deductions

Annual income of Mr. A is ₹ 9,00,000 and he has a normal deduction of ₹50,000?

• Old Regime:

Taxable income = ₹8,50,000.

Tax = ₹12,500 (5% of ₹2,50,000) + ₹70,000 (20% of ₹3,50,000) = ₹82,500.

• New Regime:

Taxable income = ₹8,50,000.

Tax = ₹15,000 (5% of ₹3,00,000) + ₹30,000 (10% of ₹3,00,000) + ₹7,500 (15% on 50,000) =₹52,500.

The new regime is evidently better here.

Example 2: High-Deductible Individual

Ms B earned ₹12,00,000 and has made deductions: 80C = ₹1,50,000, 80D = ₹50,000, HRA exemption = ₹1,00,000.

• Old Regime:

Taxable income = ₹9,00,000.

Tax = ₹12,500 (5% of ₹2,50,000) + 1,00,000 (20% of ₹5,00,000) + 30,000 (30% on ₹1,00,000) =

₹1,42,500.

• New Regime:

Taxable income = ₹11,50,000 (standard deduction only).

Tax = ₹15,000 (5% on ₹3,00,000) + ₹30,000 (10% on ₹3,00,000) + ₹45,000 (15% on ₹3,00.0) +

) of ₹1,50,000 = ₹30,000 or 20% × (₹1,50,000) = ₹30,000 and if the fair market value of land is after 10.01.2018 is higher than ₹1,50,000 but no amount was actually paid for it then in such case no amount i.e., nil would be the FMV.

If deductions are higher, the new regime provides lesser tax compared to high deductions in the above case, although it may change.

Example 3: Senior Citizen

Senior citizen with income of ₹6,00,000 after deduction under 80C (₹1,50,000) and 80D (₹50,000).

• Old Regime:

Taxable income = ₹4,00,000.

Tax = ₹5,000 (if 5% on ₹1,00,000) – Rebate under 87A of ₹5,000 = Nil.

• New Regime:

Taxable income = ₹5,50,000.

Tax = ₹12,500 (5% of ₹2,50,000) + ₹5,000 (10% of 50,000) = ₹17,500 – rebate under 87A (₹17,500)

= Nil.

Here both regimes generate zero tax, but one has to plan for incomes above this point.

7.5 Summary

- ❖ Gross Total Income (GTI) is the sum total of income under all five heads, without deductions under Chapter VI-A.
- ❖ The set-off and carry forward of losses principle is designed to ensure equity in the computation, by providing for the adjustment of losses against income in another year.
- ❖ Chapter VI-A (80C to 80U) provides deductions which support savings, investments, health expenses, education and charity.
- ❖ Section 80C is the most popular one, which includes LIC, PPF, NSC, ELSS, tuition fees and so on.
- ❖ The deduction for medical insurance premiums is available under Section 80D, whereas the benefit on education loans can be availed of under Section 80E.
- ❖ Donations get a tax break Now, philanthropy is encouraged with Section 80G deductions.
- ❖ Section 87A provides rebate to an individual residents in lower or middle income group.
- ❖ One big difference with exemptions: they exempt the income itself, whereas deductions cut taxable income.
- ❖ Farm income is excluded but only partially integrated in some instances.
- ❖ Typical items of exemptions are HRA, LTA, Gratuity, Pension Commutation and Voluntary retirement compensation.
- ❖ You can opt for the old regime (deductions allowed, higher rates) or the new one (lower rates, fewer deductions).
- ❖ Certain factors such as income level, deductions taken, financial objectives and liquidity needs influence the choice of tax regime.

7.6 Key Terms

1. Gross Total Income(GTI): Aggregate income calculated under all heads of income before allowing any deductions.
2. Gross Total Income : The GTI is net of Chapter VI-A deductions and is used as the base.

3. Exempt: Income that is not to be considered for calculating GTI, such as agricultural income.
4. Deduction: Fall in the GTI for certain investments, expenses etc.
5. Set-off: Setting off of losses from income under the same or different head.
6. Carry Forward is the ability to utilize unadjusted losses in the subsequent years.
7. Section 80C: Deductions for Investment / Payments such as PPF, LIC, NSC.
8. Section 80D: Deduction towards premium for health insurance and preventive check-ups.
9. Section 80G: Deduction for donations to certain funds and charitable institutions.
10. 87A: Rebate of income-tax in case of certain individuals.
11. Partial Integration: A system for taxing at rates slightly reduced from personal tax rates when certain types of income are included while still untaxed, and the host is not taxed on it.
12. Regime of Tax: Structure for tax rates and regulations-old regime allows deductions and new regime offers lower rates with little reliefs.

7.7 Descriptive Questions

1. Discuss what Gross Total Income is and how it's calculated.
2. Explain the provisions regarding set off and carry forward of losses under the Income Tax Act.
3. Explain Section 80C in detail. Where can I claim the deduction for eligible investments and payments?
4. Differentiate between exemptions and deductions with appropriate examples.
5. Discuss the term 'Agricultural Income' and 'Partial Integration in computation of income' 4.
6. Distinguish between the old tax and new tax as per section 115BAC along with their merits and demerits.
7. What are the points a taxpayer must consider before choosing between old regime and new regime?
8. Show by numerical example calculation of tax liability both under old and new regimes for assessee having more than one source of income.

7.8 References

1. Income Tax Act, 1961 (Bare Act).

2. Central Board of Direct Taxes (CBDT) Circulars and Notifications.

3. Annual Budget Documents and Finance Act updates by the Government of India.

4. Standard Textbooks on Direct Taxation (e.g., V.K. Singhania's Direct Taxes Law and Practice)

5. ICAI Study Material on Direct Taxes for CA and CMA courses.
6. Academic Journals and Articles on Indian Taxation Policy and Reforms.

Answers to Knowledge Check

Knowledge Check 1

1. c) Resident individuals
2. a) Deduction
3. b) Partial integratio
4. d) All of thes
5. b) Travel expenses within India

7.9 Case Study

“Tax Planning Decisions of Mr. Arvind – Choosing the Right Approach”

Mr. Arvind, whose age is 40 is a salaried employee based out of Mumbai and his annual income is

₹14,00,000. I apart from this, his rental income (after deductions) from house property is ₹1,50,000 and interest income (from fixed deposits) is ₹70,000. He also sold few shares during the year and gained ₹1,20,000 as long-term capital gains. His Gross Total Income before deduction amounts to ₹17,40,000.

Throughout the year his investments or expenses were composed of:

• Investment of ₹1,50,000 in Public Provident Fund (PPF).

• An amount of ₹35,000 paid for life insurance premium (in respect of self & spouse).

• He also pays health insurance premium of ₹30,000 for himself and ₹40,000 for his parents (both senior citizens).

• School tuition of ₹60,000 for his two children.

• Charitable donation of ₹20,000 in trust as specified in section 80G (limit with qualifying percentage of deduction: 50%).

Mr. Arvind now faces two important questions:

Under the old regime, how much taxable income should he figure?

What would his responsibility be under the new system?

What regime should he opt for to minimize his tax outgo maintaining in mind that the financial goals?

Problem Statements

Problem 1: What will be the taxable income for Mr. Arvind under old regime of tax calculation, with Chapter VI-A deductions and Section 10 exemptions?

Problem 2 : New system where deductions are not there but slab rates are less, What is his Taxable Income.

Problem 3: Suggest Mr. Arvind the regime he should opt for, given his investment and expenses, giving reasons.

Solutions

Answer to Question 1 (Ancien Regime):

• Salary Income = ₹14,00,000

• House Property = ₹1,50,000

• Interest Income = ₹70,000

• LTCG = ₹1,20,000

• GTI = ₹17,40,000

Less: Deductions under Chapter VI-A

• 80C (PPF + LIC + Tuition Fees) for ₹2,45,000 only > Instead of 1.5 lakhs!

• Deduction under Section 80D (Self and family ₹30,000 + Parents ₹40,000) = ₹70,000 (capped at the ceiling of ₹75,000; in order to become eligible for full deduction one may consider buying an additional health insurance policy to the extent of deficiency of deductible).

= ₹70,000)

• 80G (Donation ₹20,000 limit 50%) = ₹10,000

• Total Deductions = ₹2,30,000

Taxable Income = ₹15,10,000 (after deductions; LTCG is separate from this). Tax Calculation:

- On ₹13,90,000 (excluding LTCG): Progressive slab rates under old regime.
- LTCG ₹1,20,000 is taxable @ 10% = ₹12,000.
- Effective tax would be slab rates + LTCG + cess.

Answer to Problem 2 (New Regime):

- Salary = ₹14,00,000
- House Property = ₹1,50,000
- Interest = ₹70,000
- LTCG = ₹1,20,000
- GTI = ₹17,40,000

Deductions almost all ineligible, only Standard Deduction of ₹50,000 allowed.

- Taxable Income = ₹16,90,000 (+ LTCG).
- Income from LTCG tax to be replaced with new regime slab rates + LTCG @10%.

Solution to Problem 3 (Choice):

- For old regime, Arvind avails a handsome benefit of ₹2,30,000 as deductions.
- Under new regime, deduction is available only for ₹50,000, higher taxable income.
- Given his high level of investment and spending, the old regime is more tax efficient.
- He should opt for the old regime, but continue to maintain his prudent financial habits in savings and insurance.

Reflective Questions

What would have been the result if Mr. Arvind had less benefit of deductions available to him under Section 80C and 80D?

Under what conditions does new system would be better even though the deductions are less Let’s seeidl_}. __________ _-isdiction in China.

What Will be The Impact of change in 87A under the new and old regime on tax planning for Middle income group?

Is tax planning about minimizing the tax burden, or can that planning be melded into larger financial goals like retirement and liquidity?

How is partial integration of farm profits fair in the context of income tax?

Conclusion

The predicament of Mr. Arvind shows the difficulty in deciding between the old and new tax systems. The new regimen is streamlined and accompanied by a lower tax rate, but it is not always favorable for taxpayers with big deductions. For people like Arvind, who tend to allocate more of their savings towards saving, education and health care in the normal course of events, the old regime is still tax efficient. The exercise perhaps illustrates that tax planning is not so much an exercise of minimizing liability but rather something that should be seen quite holistically as part of financial management, balancing what you need or want now with the long-run plan.

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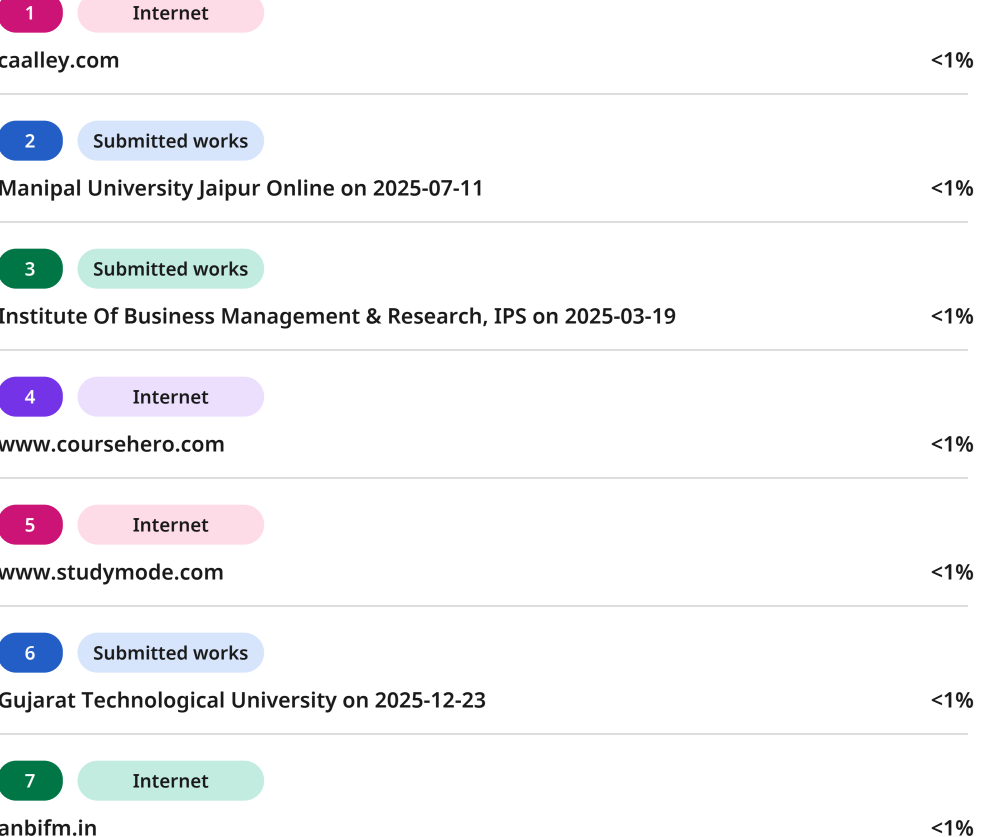

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Unit 8 Introduction to Indirect Tax & GST Concepts

Learning Objectives

1. Understand the fundamental differences between direct and indirect taxes within the Indian taxation framework.
2. Explain the historical evolution and the need for implementing Goods and Services Tax (GST) in India.
3. Identify the various types of indirect taxes that were subsumed under GST.
4. Describe the structure of GST including CGST, SGST, IGST, and UTGST.
5. Recognize the key concepts of GST such as supply, input tax credit, reverse charge mechanism, and composition scheme.
6. Analyze the benefits and challenges associated with the implementation of GST.
7. Understand the GST registration process and compliance requirements for businesses.
8. Evaluate the impact of GST on various sectors and its role in promoting a unified national market.

Content

8.0 Introductory Caselet

8.1 Concept of Indirect Tax

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8.3 Comparative Analysis with Previous Tax System

8.4 Summary

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8.6 Descriptive Questions

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8.8 Case Study

8.0 Introductory Caselet

"The Tax Reform of Vardhan Electronics Pvt. Ltd."

Vardhan Electronics Pvt. Ltd. was founded in 2004, Our company is a developing medium-sized enterprise which owns the ability of researching and producing to provide consumers electronic products---- LED TV s, home theatre systems and air purifiers etc.. Based in Pune, the firm had been selling its product to multiple states of India and thus having to handle a variety of different tax compliance.

Pre-GST Era Challenges

Prior to the implementation of GST in 2017, Vardhan Electronics functioned amid a labyrinthine set of taxes. They were subjected to several indirect tazes such as:

• and VAT of independent States,

• Central Excise Duty on manufactured goods,

• Service Tax & levied on services like after sales service,

• Central Sales Tax (CST) in case of inter-State transactions,

• Other local taxes such as Entry Tax and Octroi levied by local bodies.

Each tax required its own system of compliance, filing of returns and payment schedules. Also there were no integrated credit tax system of Indirect Taxes, resulting in taxation of already taxed inputs cascading of taxes. For instance, the company's VAT was previously on top of excise duty already paid for raw materials.

Logistics amounted to a headache, too. There were check posts, which caused delays in goods crossing borders of different states, leading to high logistics costs. Keeping the company compliant with tax requirements took a lot of effort, it would require a dedicated finance and legal team.

Transition to GST

The Good and Services Tax, which absorbed nearly all indirect taxes into a nationwide taxation system, was introduced in July 2017 by the Indian government. Vardhan Electronics had to:

• Make the transition to GST by registering on the GST portal and,

Change their billing/ERP systems to include components of GST (CGST, SGST and IGST),

• Prepare GST-compliant invoices and file according to law, click here to learn more. • Train their staff for GST compliant invoicing and filing technologies here to know more.

The transition was initially difficult. Short-term disruptions Uncertainty on product classification under the GST rates, frequent changes in policy and some technological challenges were short-term disruptions. But pretty soon the firm began to see positive effects.

Post-GST Benefits

ITC got simplified. The company was entitled to a credit for the GST it had paid on inputs, services and capital equipment at each stage of the production process.

There improved logistics efficiency as a result of elimination of check posts and inter state which led to reduction in delivery timelines.

This introduced universal pricing between the states and increased market based competition.

The simplification in compliance was because only one instead of multiple returns had to be filed.

Notwithstanding the pluses, additional problems still plagued the company:

• Rate changes affecting product margins,

Technical errors on the GSTN site,

• Problems in interpretation in as far as exemptions and reverse charge mechanisms are concerned.

However, on the whole compliance improved, costs decreased and scaling business operations became easier.

Critical Thinking Question:

Based on Vardhan Electronics Pvt. Ltd., explain how the introduction of GST might bring about different gains and challenges for small businesses (e.g., sole traders or micro enterprises) as compared to medium sized and large companies. Take account of digital literacy, compliance costs and the availability for professional advice.

8.1 Concept of Indirect Tax

An indirect tax (such as sales tax, value-added tax (VAT), or goods and services tax (GST)) is a charge on an intermediary such as a producer or retailer who then "passes the cost" to the final consumer in the form of higher prices. Indirect taxes, which are applied to both goods and services, rely on final consumers and thus are consumption taxes. It may take the form of GST, customs duty and excise duty etc.

8.1.1 Definition and Characteristics of Indirect Tax

An indirect tax is one that is levied on goods and services rather than on income or profits. Under this tax, the person who pays tax and the bearer of the burden are two different persons. The tax is collected by the vendor, manufacturer or service provider from the buyer and then remitted to the government. This arrangement makes sure the final liability of tax is being borne by the end consumer, and not toady intermediary that just acts as a gathering agent for government. Whereas direct taxes are directly payable to the government by the taxpayer, indirect taxes are levied on companies who pass them on to the consumer in a product's price.

One of the characteristics of indirect taxes is their shiftable nature. The tax is actually paid by the seller or the service provider to the government, but is shifted further till it finally reaches a buyer. This characteristic allows the ultimate consumer to bear, instead of the government or the producer, the final tax burden. The other taxes as indirect ones, in their turn of difference levels, are established at several stages of the supply chain (production, distribution and final consumption). This mechanism of collection makes them an important resource for revenue generation in varied sectors of the economy.

Another important feature of indirect taxes is their regressive rigidity. They apply equally to all people, rich or poor. Consequently, low-income people end up paying a higher share of their income in taxes for goods or services that they purchase and the tax burden falls more heavily on poor than on rich. In terms of tax design, indirect taxes are typically consumption-based. They spend more, they pay more tax. Such a system encourages savings and discourages too much spending, although if not accompanied by exemptions or lower rates for necessities it can also restrict access to necessary purchases.

Broad-based application The indirect taxes also have wide-ranging application in several industries or sector. Since the taxes are imposed at the time of a transaction, and not on income, almost all economic entities - individuals, companies, institutions—get drawn into the tax net through consumption. Also, the indirect tax collection method is often integrated into the price system, which means that, for the final buyer, it is psychologically less painful to pay it.

to accept. This also mitigates the risk of people choosing not to pay tax on purpose, although business compliance is still needed.

Furthermore, government finds it convenient to collect indirect taxes. Rather than attempting to chase down millions of individual taxpayers, government collects tax from a smaller set of businesses — the ones who supply goods and services to the taxed individuals — that function as tax collectors. The former structure simplifies management and enhance efficiency of revenues. But despite these benefits, indirect taxes are also inflationary. Because they make goods and services more expensive, they can translate into widespread inflation, which influences the cost of living. And by the fact that indirect taxes are not according to ability to pay, there are issues about fairness and equity in taxation."

Thirdly, those availing the benefit of indirect taxes need not declare any income or revenue in personal or business because it lures participants from informal and unorganized sector. They are collected as part of commercial exchanges, and all those who consume goods or services indirectly pay taxes to the government, so indirect taxes also is a practical and frequently used tax system in national finance.

8.1.2 Distinctions between Direct and Indirect Taxes

The essential difference between direct and indirect taxes is the subject of each tax, as they have different objects and are based on different principles. A direct tax is a tax levied directly on the individual or organization that pays it, and canna down to others. This can be for things like income tax, corporation tax or wealth tax. In comparison, a direct tax is one that cannot be passed on and the intermediary bears its burden while passing it on to the end consumer from whom it can collect it. Examples: The most common example of indirect tax is GST, customs duty and excise duty.

Where these two are concerned, a main difference is the shiftable of tax burden. Transferability: Direct taxes cannot be shifted, as that duty is bound only to borne by the taxpayer. Its income must be directly taxed by the government. With indirect taxes, however, the burden of payment can be shifted to the consumer by including the amount in the cost of goods or services. This makes the latter more elastic and easier to collect in economy based on consumption.

A further difference between them is in terms of internal equity and justice. Direct taxes are said to be progressive, for they are based on ability to pay. For instance, those who earn more pay a higher tax rate. Therefore, there is a certain amount of wealth redistribution. However indirect taxes are regressive as they are flat—rate tax imposed regardless of the income level. In consequence they take a bigger bite than ever from the (>income of the) poor than from the rich. Such a situation is concerning in terms of social justice, especially for the working classes and poor who end up paying at the same rate as luxury consumers.

On the compliance side and on evasion, direct taxes are more exposed also in a context where under-reporting of income is usual. Also harder to evade are the indirect taxes, which operate like VAT and GST, being embedded in everything that is bought and sold by business. This makes them a more stable source of government income, particularly in the developing world

where huge informal economies still exist. But indirect tax collection is built on sound systems and honest business.

Administratively, there is also a point of difference. One reason why most governments prefer to collect indirect taxes is because there are fewer collection points (business or dealer, for example) compared to the millions of individual and entities from whom direct tax could be collected. This unified collection system drastically reduces the cost of tax administration. On the other hand, direct tax systems involve a lot of paperwork; income verification and assessment and is are more resource intensive.

Furthermore, the indirect taxes affect market prices and consumption levy. For example, indirect tax rates on alcohol or tobacco can be set at a high level for policy reasons to deter consumption of harmful goods. 2 However, direct taxes do not influence consumption decisions in a manner similar to indirect levies since they are distinct from the transaction of goods or services.

Despite these distinctions, both are crucial for a healthy fiscal system. Direct taxes provide equity and redistribution, while indirect taxes ensure extensive coverage and stable revenue. There is no right answer between the two that will bring about economic efficiency and social equity.

8.1.3 Examples: GST, Customs Duty, Excise Duty, etc.

There are many varieties of indirect taxes in the overall gamut of a country's fiscal policy. Of them, GST, customs and excise duties are the most prominent and levied on a large scale. All three of these taxes have a unique legal form, function and role in the economy. Learning how they work (operation) gives you insight on the manner in which government obtains their revenues by way of consumption- based tax.

The Goods and Services Tax (GST) is a broad-based tax of 10% on most goods, services and other items sold or consumed in Australia. The Indian tax system was fragmented prior to the introduction of GST, with disparate taxes like VAT, central excise duty, service tax and various state levies. GST amalgamated these under one tax head making collection and compliance far easier, and eliminating cascading effects of tax-on-tax. GST is applied at each point in the chain of production but because credit is allowed for tax paid on inputs, the ultimate burden in that respect falls on final consumers only. The system comprises three components: Central GST (CGST) is collected by the Central Government, State GST (SGST) is collected by the State Governments on intra-state transactions and Integrated GST (IGST) is collected by the Central Government for inter-state transactions. GST is a destination based tax, which means the tax would accrue to the State where the goods are consumed and not production. This system has greatly increased transparency, tax-compliance and ease of doing business.

Another big example is customs duty or the type of indirect tax that is levied on goods imported in and out of a country. It is a two-edged weapon, in the one hand enriching the revenue and on the other restraining commerce by rendering foreign articles more costly and domestic cheaper. In India, customs duties are handled by the Customs Act, 1962. The principal types of duties are the: 1.Basic Customs Duty (BCD) imposed @ the rates prescribed in the Customs Tariff Act; 2.Countervailing Duty (CVD), which is equivalent to the excise duty imposed on similar goods produced or manufactured in India; 3.Anti-dumping Duty, in case imported goods are dumped into Indian market at prices lower than their normal value and causes material injury to domestic industry 4.Safeguard Duty, temporary measure that offers protection to a domestic industry against an increase in imports. Tariffs can also be used for strategic reasons, such as limiting the import of dangerous products or addressing a trade imbalance.

One of the indirect taxes and a key while it existed, was Excise duty that applied to goods produced within the country. It was mainly applicable to articles like petrol products, tobacco and liquors. While most of the excise duties have been included in GST, certain items are kept outside the GST and these products still attract central excise duty. The duty of excise was paid by the manufacturer on the removal of goods from his factory and it had been passed ultimately to the consumer since the same was factored into the price. The residual excise duty architecture, post-GST, essentially caters to non-essential/harmful goods and thus provides the government leverage to use it as revenue measures and for better scales of check on consumption.

Service tax, which was imposed on certain services rendered by businesses, professionals and service providers, was also a previous category of indirect taxes. Service tax was levied on service provider but actually borne by service receiver. Service tax has been completely subsumed into GST regime. As well, statuary taxes like luxury tax, entry tax and entertainment are got subsumed under the GST to make it simpler.

Accordingly, the indirect tax regime has witnessed major changes over the recent past. From the earlier era of multiple and overlapping taxes, GST now stands out as the hegemonic indirect tax with most old levies subsumed under it but some duties like customs duty and certain specific excise falling outside its domain, playing distinct fiscal and regulatory roles. These taxes embody the complexity of indirect tax structure and varied purposes it serves ranging from revenue raising to economic management and insulation of indigenous industries.

8.1.4 Merits and Demerits of Indirect Taxation

Intriduction to the system of collecting revenues by taxing the consumption of goods and services is a very advantageous one, from the standpoints not only of governments but also of business concerns and consumers. But it has its own share of downsides, particularly with

respect to equity and the economic hardship on those at the lower end of the income scale. A careful comparison of the advantages and disadvantages gives explanation for why such taxation remains fundamental to public economics systems worldwide.

One of the most important advantages of indirect taxes is that it covers a wide spectrum. And since they tax the value of things purchased, not one's ability to pay, everybody who purchases goods and services foots a share of government bills. Such a large base of operations enables reliable and high volume sales, particularly in consumer-driven economies. Even people who are not part of the formal economy, or not paying income taxes get to contribute indirectly from their pockets toward public funds as well. This broad applicability enables governments to achieve fiscal targets without being burdened by overdependence on direct taxation systems, which are frequently underutilised in emerging countries that have a significant informal sector.

Compared to direct taxes, the administration and collection of indirect taxes is less complicated. They are collected based on the point of sale or importation by registered dealers/services providers, who pass the collected tax to the government. This would in turn decrease administrative complexity, reduce the cost of tax collection, and increase compliance by reducing the number of entities subject to direct monitoring. and it makes tax evasion more difficult because it's hard for a consumer not to pay a tax when that tax is built into the price of what he or she is buying taxes as payment.

Further, indirect taxes can be well-targeted and adjusted to affect consumption behavior. For example, high excise duties on cigarettes, alcohol and luxury goods help in discouraging the use of non-essential or harmful products. These are, typically with slurs so people know you're being sarcastic, "sin taxes" – paying the cost of a social ill through its consumption. They can make indirect tax policy a contra-cyclical instrument, cutting rates to boost demand during downturns and raising them when inflation is accelerating.

But indirect taxes, too, have their substantial demerits. That the latter are regressive is the most important of them. Indirect taxes are not graduated, meaning they treat all consumers the same despite the level of income. The effect of such a policy is that the poor pay more sales tax than the rich, especially when they buy necessities. This is in stark contrast to progressive direct taxes, which tax higher income earners at a higher rate taking account of their greater ability to pay.

Secondly, indirect taxes are obscure or not transparent. Because the tax is part of the price of a good or service, consumers are often unaware how much tax they're truly paying. This opaqueness may lead to a gap between the public and what the state does with their money and in turn, reduces accountability and transparency in tax policy.

Indirect taxes can also be inflationary. Due to the fact that these taxes raise prices of goods and services, they can potentially drive up general price levels in the economy. If the rates are high enough, they may be used to discourage consumption of the product and negatively

affect demand, especially for price-sensitive products such as spirits. The impact is especially severe in developing countries, where basics are a large share of total household spending.

Further, the simplification rules might make compliance difficult under regimes such as GST. Businesses, especially small companies, could find the requirement to file electronically, submit many returns and rates that are in constant flux troublesome. Arguments over classification, technology snafus on filing portals and constant policy shifts can make compliance even more of a nightmare.

Summary: Although indirect tax systems have the advantages of economic efficiency, wide coverage and high revenue elasticity, they can also raise a lot of problems in terms of fairness, transparency and inflation. Policymakers have to weigh these considerations in designing their indirect tax structures – sometimes by adopting differential tax rates, exemptions on key goods and services or using direct cash rebates for the poor- then want to introduce taxes while keeping fiscal capability intact and maintaining social equity.

8.1.5 Role in Revenue Generation and Consumption-Based Taxation

Which are indirect taxes in the financial system? They are not only important sources of income for governments but also tools to affect consumers' behaviour and control economic activities. They are also particularly good at raising revenue in a stable and efficient way, because of the underlying structure that links tax to consumption, rather than income.

Revenue generation is one of the main objectives of indirect taxes. Indirect taxes are similarly economic-based and exclude taxes on income or transaction flows, but can include broad forms of consumption tax including value added tax or goods and services tax. Since all members of society consume goods and services, indirect taxes are a way to achieve more people contributing to the public coffers, though not through income tax. This would make them more inclusive and practical for a country that has a large informal or agrarian economy, where it may be difficult to monitor income at the individual level. Governments find it easy to collect because the supply chain and its participants, businesses that act as a tax collector in any tax collection process, are 'wired' for automatic collection at the point of sale.

Indirect taxes are also quintessentially consumption taxes. The more a person or entity uses, the more tax they pay. This scheme follows the rule of taxing on consumption not on earning. It provides an embedded incentive to save and invest – only when one consumes does a tax event occur. This can help even out the economy by promoting forms of investment and discouraging wasting, particularly over luxury or non-essential goods.

And because indirect taxes are applicable to every transaction, they raise cash on a flow basis rather than in lump sums for the government. Unlike tax revenues, which can be seasonal or economic sensitive. Indirect taxes also help the government track consumption trends and frame fiscal policies accordingly. For example, if demand for imported luxury goods suddenly

increases it may cause the government to increase customs duties to place an added barrier of protection on domestic industries or reduce trade imbalances.

An indirect tax is also desirable because it enables macroeconomic management. Governments can use progressive taxes to single out certain goods or services with higher tax levies for social or economic reasons. For example, taxing tobacco, alcohol and sugary drinks not only raises money but also advances public health goals. Likewise, tax exceptions or reduced rates for essential commodities such as food grains, education and preventive healthcare services bring in them affordability and social security.

Notwithstanding these benefits, however, depending on consumption as a tax base can be regressive if not properly structured. Necessities, which are consumed by rich and poor alike, when they are taxed at same flat rate, can lead to regressivity. To prevent this, unlike their traditional counterparts, modern indirect tax regimes have deployed a variety of tax slabs, zero- rated items and exempted commodities. India's GST structure, for example, covers four large rate bands and has entire essential class kept out of tax.

Finally, we come to the point that indirect taxes are a necessity for modern economies. They offer an unfluctuating, efficient and adaptable system of financing public expenditure together with a means for governments to purposely will for consumption patterns and industrial policy. Yet their power is contingent on the quality of their design: good tax reforms in which the revenue requirements command a balance between equity and economic efficiency.

"Activity: Tracing the Tax Trail"

Each student will select a common consumer product (e.g., snack, phone, clothing) and independently trace its supply chain from raw materials to consumption. They will identify applicable indirect taxes at each stage, explain tax burden transfer, and create a short infographic or slide showing effects on final price.

8.2 Basic Principles of GST

Introduction Goods and Services Tax GST is a major transformation in India's taxation information system which has a scope of substituting the existing indirect taxes with a transparent and technologically driven system in India. Simplified tax structures, absence of cascading effects, is smooth flow of credit across the chain and establishing a common national market are the broad principles of GST. At a fundamental level, GST is a consumption tax on the supply of goods and services. In contrast to the regime in question, the GST takes its tax base as "supply" and not manufacture, sale or rendering service. This transition not only rationalizes the tax regime, but also streamlines compliance. Knowing its origin, types,

structural model and important features such as Input Tax Credit (ITC) are vital to understand the way in which GST operates within India's economy.

8.2.1 Origin and Objectives of GST in India

Introduction of Goods and Services Tax The introduction of the GST was a response to the longstanding demand for reform of the outdated and inefficient multiple-tax system that prevailed in India before 2017. Before both the central and state governments were to impose multiple taxes such as excise duty, service tax, value-added tax (VAT), central sales tax(CST), luxury tax, entertainment tax, and so on with its own set of rules -and for the taxpayer it was compliance requirements/rules and credit taking mechanisms. Effect of cascading They argued that the cascading effect of of taxes--tax on tax--lead to distorting costs for consumers and wastage in the supply chain.

The first informational report on GST was considered by the Georgeson Committee in 2005. The 2003 report of the Kelkar Task Force on Indirect Taxes recommended that India establish a comprehensive GST to integrate all indirect taxes into a single tax. The Constitution (101st Amendment) Act, 2016, was then passed in order to introduce GST. The tax was unveiled on July 1, 2017, a landmark day in the history of India's taxation.

The Significant Aims for Introduction GST are:

• Eradication of the Cascading Tax Regime: A significant aim was to eliminate cascading taxation (the earlier system resulted in a tax on tax). GST provides for a seamless flow of credit wherein the tax paid as input can be taken as credit so there is no cascading effect.

• Creation of One National Market: GST intended to abolish inter-state tariffs and provide for simpler movement of goods and services across India by replacing a host of central and state taxes.

• Reduction of Tax Complexity: GST eliminated the need for businesses to navigate various indirect taxes as a single tax was introduced instead, simplifying compliance requirements and lowering administrative costs.

• Rise in Tax Compliance and Revenue: The advent of GST was meant to bring about an expansion in tax base because of the increase in transparency, digital invoices and sturdy compliance systems such as GSTN (Goods and Services Tax Network) that electronically tracks all transactions.

• Impetus to 'Make in India' and Economic Growth: A single, streamlined tax system will promote domestic production and increase the international competitiveness of Indian produced goods by decreasing taxes overall.

Besides these twin goals, the GST was introduced to promote cooperative federalism where both central and state levels of government are equally entitled to collect taxes. That was

accomplished through the GST dual system of shared tax between the Centre and States, so that each of them could maintain fiscal autonomy even as becoming part of an integrated tax mechanism.

8.2.2 Type of ST/GST:CGST, SGST, IGST, UTGST

In India we have GST dual model, that is both centre and state government can tax a single transaction. The system maintains equality of taxes between the Centre and the States, thereby promoting fiscal federalism. GST has two different kinds namely, depending on the type of supply (intra-state or inter-state).

CGST – Centralised Goods and Services Tax

CGST – This is the tax collected by the Central Government on Intra – State supply of both goods and services, which means that the place of supply and location of supplier are in same state. The amount of CGST is retained by the Centre. It substitutes taxes such as central excise duty, service tax and additional customs duty.

SGST – State GST (Goods and Services Tax)

SGST is charged by the State Governments on Intra-state sales along with CGST. The proceeds earned is deposited in the concerned state government account. SGST would replace the existing taxes like Value Added Tax, luxury tax and entertainment tax. The rate of CGST and SGST is generally same and equally divided between Centre and State. For instance, if an item is taxed at 18%, then 9% would go to CGST and 9% to SGST.

Which is better, GST or IGST?

IGST is levied on inter-state goods and services supplies, including imports and exports. It is imposed and collected by the Central Government, while being later reimbursed to Centre/destination State. IGST prevents breakage of credit chain, whether in goods or services while relocating these to another state. It circumvents the tiresome process of CST and restriction of input credits as previously existed.

UTGST – Union Territory Goods and Servi..

UTGST is for Union Territories without legislature which include Andaman and Nicobar Islands, Lakshadweep, Dadra and Nagar Haveli Daman and Diu. It is applied in lieu of SGST, along with CGST, for intra-union territory supplies. The Union Territory administration, as in case of SGST, will collect UTGST.

The dual GST structure has been designed to retain the constitutional feature of taxing powers between the Centre and states and yet creates a convenient way of taxation. Since representatives of both the Centre and States are part of GST Council which decides on rates and settlement of disputes, cooperative decision making is ensured. This multi- layered

structure helps in ensuring a fair distribution of GST revenues for further devolution and protects the fiscal autonomy of centre and states.

Figure 8.1

8.2.3 Destination-Based Tax and Dual GST Model

Destination-based tax A unique feature of the Indian GST is that it is a destination-based tax as opposed to a point of origin-based tax. This is a move away from the previous system where taxes were collected by the state in which goods were produced, resulting in skewed revenue distribution. Under the destination- based model, tax revenue is sent to the state where goods or services are actually consumed — not where they're sold from. This model brings justice to the sharing the revenue between consuming states and is in consonance with overriding principle of fiscal federalism.

The destination-based taxation under GST eliminates the distortions that existed previously where producing states used to earn more compared with consuming ones because, of origin-based taxes such as central sales tax. For example,if a Maharashtra based manufacturer sells goods to Karnataka based dealer then IGST is levied by Central Government and the same would be apportioned to the destination state of Karnataka. It has the advantage of preventing revenue loss to the consuming states and promoting equity in tax sharing.

This will be complemented by the dual GST model followed in India, that enable both the Government of India and state governments to simultaneously levy Goods and Services Tax on a common tax base. The dual mode was chosen to accommodate the federal nature of Indian Constitution, in which both levels of Government should have independent taxing

powers. Accordingly, intra-State supplies are liable to CGST and SGST/UTGST whereas inter-State supplies are liable to IGST.

It is a convenient way out for India's peculiar political and administrative set-up. It provides fiscal autonomy to each level of government, and the advantages of a common tax base. The GST Council emerges as critical to keeping states in sync, deciding on tax slabs, exemptions and procedures – less the new tax beget myriad of barriers it was meant to do away with.

This architecture also eliminates the CENVAT cascading to a very large extent since the tax paid at each successive stage of supply is fully creditable. The tax is collected only on value added at each stage of the production process and its credit system ensures that tax paid on inputs is charged against liability on output. It also promotes national-level pricing, lowers the cost of compliance for businesses operating in one or more states, and facilitate ease of doing business.

Read : Importance of Place of Supply in GST The destination-based principle along with the dual tax model will help in realization of common national market and fiscal federalism. iii)Establishes a common market by creating similar tax and revenue sharing systems at national and state levels, which ends bottlenecks and inefficiencies caused by the current multiple tax system.

8.2.4 Supply as the Taxable Event under GST

In the era of India's last indirect tax system, different taxable events would trigger different taxes. So, there was excise on manufacture; VAT on sale and service tax on services. This piecemeal method resulted in confusion and the possibility of overlap, dispute and multiplication of taxation. To ease these issues, GST brought in a single taxable event called "Supply" which was very broad based. All taxes come under the GST regime on supply of goods or services rendering an uniform and consistent system across sectors and states.

1,18,585 IN THE SUPREME COURT OF INDIA CIVIL APPELLATE JURISDICTION Civil Appeal No. As per Section 7 of the CGST Act, 2017, supply includes all forms of supply of goods or services and includes sale, transfer, barter, exchange, license rental lease or disposal made or agreed to be made for a consideration by a person in the course or furtherance of business. This definition binds nearly all commercial goods or services transactions within the scissors of tax net.

Three main features determine whether a transaction is a taxable supply:

There needs to be a provision of goods or services or both.

It should be a supply for consideration (with exception of the cases as defined in Schedule I where value is treated as being taxable even if there is no consideration).

The supply must then be in the course or furtherance of a business.

For some very special cases, if with no consideration GST would still be applicable. They are prescribed under Schedule I of the CGST Act which include: transfer of business assets permanently, supply between related persons, supply between distinct branches and another branch in other state, principal to agent or vice-versa. These provisions help maintain the tax trail even for non-cash or inter-site deals.

Secondly, the Schedule II of CGST Act makes it clear that whether an activity should be treated as supply of goods or services. "Lease of an immovable property is treated as supply of service and if there be any transfer of right in goods without the transfer, them is also a service. It also solves the ambiguity problem and contributes to tax law uniformity.

Supply may also be classified as intra-state or inter-state depending on the location of supplier and place of supply. Wherein if supplier and recipient are within the same state/UT then supply would be intra-State and CGST / SGST/UTGST is payable. If they are in different states or Union Territories then it is deemed as inter-state and IGST tax applies on the same.

IGST Act Place of supply rules are important to ascertain the nature of supply and type of GST applicable. For things, the place of supply is typically where the goods are delivered. The rules are more complicated for services, which depend not just on the nature of a given service but also on where its recipient is located.

Moreover, the notion of a composite and mixed supply is brought in to explain taxability when more than one goods or services are supplied as a package. Composite supply is a supply comprising two or more supplies, which are naturally bundled and supplied in conjunction with each other, one of which is a principal supply. The tax rate for the principal supply is imposed on the entire package. For instance, a package of supply of goods along with free installation is a mixed supply. On the other hand, a mixed supply is a combination of two, or more than two, separate supplies which are not naturally bundled together. The highest GST rate levied on any of the items in the bundle is charged.

So, supply is the most basic taxable event under GST that consists of many more things. This model renders clarity, eases compliance and uniformity across various industry and states/regions paving way for a sound indirect taxation system.

8.2.5 Input Tax Credit Mechanism

Input Tax Credit (ITC) is one of the pathbreaking features of GST, wherein a business can claim credit for the tax already paid on its inputs (i.e., goods or services used in providing an output supply), and apply it against the tax they have to collect/output supplies. The ITC structure is intended to remove the tax on tax concept or cascading effect of taxes - the tax which was earlier present in a product had already been included while taxing the next stage of transaction. This mechanism guarantees that GST is levied only on the value added at each stage while enticing honesty and efficiency in tax administration.

ITC vs fiscaes liability Under the ITC provisions, a registered person can avail of set-off on the tax paid on their purchases (input goods/ input services / capital goods) against their output tax liability on sales or supplies. For instance, if a trader buys goods worth ₹1 Lakh and pays ₹18,000 as GST (input tax) and then he sells the said goods for

₹1,50,000 and the trader collects ₹27,000 as GST (output tax) then he can take credit of ₹18,000 and pay only the balance amount of ₹9,000 to the government.

But not all input taxes are recoverable. There are 'conditions for claiming Input Tax Credit' which one needs to fulfill in order to avail the ITC:

A tax invoice or debit note issued by a registered supplier.

Delivery of goods or services (or both).

Supplier''s tax liability Tax charged by the supplier must have been paid to the government either in cash or in ITC.

Submission of GSTR-3B under GST for the relevant tax period.

Besides, input tax credit is not allowed in certain cases — on personal use, goods lost/stolen/destroyed, free samples and for certain supplies such as food and beverages or club memberships (unless used as further supply). Section 17(5) of the CGST Act talks about these limits.

For the sake of transparency and to curb misuse, GST accords matching concept for ITC wherein the credit will get allowed if the supplier has reported such invoice in his returns (GSTR-1) as well, which gets reflected in recipient's GSTR-2B. The standard has helped to decrease bogus billing and evasion of taxes. The auto-

auto-populated input tax credit statement (GSTR-2B) enables the ease of reconciling with suppliers invoice wise.

Reversal of credit is another important aspect of ITC, which might have to be done in multiple scenarios like non-payment to supplier within 180 days from the invoice date or if the inputs are used partly for making exempt supplies or personal consumption. In such situations, the taxpayer must repay the credit plus interest.

Input service distributor (ISD) is a mechanism created under GST to distribute the credit of tax charged on inputs or input services used by a supplier while supplying taxable goods and/or services source through different units. Further, on the capital goods side one could avail of full input tax upfront, when previously it was spread over years.

ITC is the key component for the value-added tax chain under GST. It ensures that tax is paid only on the net added value at each stage and hence the system is economically efficient. Firms profit from lower costs, better cash flow and more agile operations. At a macro level, it promotes the formalization of the economy and increases voluntary tax compliance.

But stumbling blocks persist—the kind that can stall, like technology bugs, bad reconciliation or frequent tweaks to ITC rules. Real-time updates, strong internal checks and reconciliation on a regular basis, these have all become key aspects for companies to make the most of credit and stay compliant with GST.

Practical Example of ITC Mechanism

Lets take an example and understand-lets say a furniture manufactuer purchases raw wood amounting to ₹5,00,000 paying 18% GST = ₹90,000 as input tax. The manufacturer later sells the finished furniture to a wholesaler for ₹8,00,000 and applies 18% GST =

₹1,44,000.

•Tax Paid: ₹90,000 (on wood)

• Output Tax Collected (furniture): ₹1,44,000

• Net Tax Payable after ITC: ₹1,44,000 – ₹90,000 = ₹54,000.

Here, the producer pays based on value addition (₹3,00,000) and not to entirety of the amount transacted. This avoids cascading of the tax and ensures that GST is charged only on the value added.

Knowledge Check 1

Choose the correct options:

1. GST in India is primarily a:

a) Origin-based tax

b) Income-based tax

c) Destination-based tax

d) Export-based tax

2. IGST is applicable on:

a) Intra-state supply

b) Import & export

c) Exempt supply

d) Personal use items

3. Supply under GST includes:

a) Only sale

b) Only services

c) All commercial transfers

d) Personal transfers

4. ITC can be claimed only if:

a) Payment is made in 30 days

b) Goods are gifted

c) Goods/services are received

d) Sale is within same state

5. UTGST is applicable in:

a) All states

b) Metro cities

c) Union Territories

d) SEZ zones

8.3 Comparison with the Old Tax System

The implementation of the Goods and Services Tax (GST) was a structural reform in India‟s indirect tax system. This section evaluates the pre-GST indirect tax system and GST with respect to structural inefficiencies, cascading taxes, reformed impacted by GST in form of

ease of doing business and improved transparency. It also explores the transitional issues of concern to taxpayers as well as the government.

8.3.1 Pre-GST Indirect Tax Structure (Excise, VAT, Service Tax, etc.)

India's pre-GST indirect tax system was fragmented and complicated, with a plethora of taxes charged by the central government as well state governments at various levels in supply chains. The central government levied taxes like Central Excise Duty, Service Tax, Customs Duty and Additional Duties of Excise where as the state governments had powers to levy Sales Tax (VAT), Entry Tax, Entertainment tax, Luxury tax and Octroi. Those taxes had been under a range of laws, rates, definitions and requirements for compliance, so being joined together in the new system had created complexity and bafflement among both businesses and buyers.

CENVAT was a tax on goods produced in India, known as Central Excise Duty. It was only at the manufacturing level, and was based on the Central Excise Act 1944. It did not cover traders or retailers and frequently resulted in valuation disputes. Service Tax was a tax on the service providers and it was passed forward to the recipient of the taxable service. It was implemented in 1994 and subsequently changed many times notably with the introduction of Negative List and Place of Provision rules.

At the state level, VAT was applicable on sales of goods and differed widely from one state to another in rates and classification of goods. It was a destination-based tax, where input tax credit would be available in the same state only. But inter-state transactions were charged with the Central Sales Tax (CST), for which no credit was allowed, causing this to be a drain on businesses.

There were other levies such as Luxury Tax, imposed on high-end hotels and specific merchandise; Entertainment Tax, charged at cinema halls and amusement parks'; Entry Tax/Octroi, collected for bringing goods into a municipal or state boundary. All of them had separate filing procedures and filings.

This double tax system resulted in various complications like different rates across states, multiple registrations, broken chain of credit etc. Tax compliance was burdensome, as business had to keep separate records and file different return for each of the taxes. There was no coordination or coherence in the tax system and transaction costs as well as cost of doing business had become more difficult for businesses especially those who were working across states.

8.3.2 Cascading Effect of Taxes in the Old System

Tax on tax" cascade was one of the most prominent adverse aspects of pre-GST era. Cascading arose when a value was taxed, and the added tax also became part of the taxable

value, resulting in a higher tax than under single-state taxation. This was due to the non-availability of cross-credit of central and state taxes, dockets and tax like excise duty, service tax and VAT.

For instance, if a manufacturer bought raw materials he was charged excise duty as well as VAT. Once they had produced the goods and sold them to a distributor, excise duty was charged again on the end product. The distributor in his turn also paid VAT on the face value of such goods (which amount he had to receive because it contained the excise duty part). This was leading to multiple taxation of the same transaction for lack of credit between central excise and VAT.

The problem was even more acute in inter-state dealings. There was a Central Sales Tax(CST) on transfer of goods from one state to another. CST was not eligible as credit which meant business could not utilize the CST paid on inter- state purchase to adjust against the output tax liability. This led to higher prices, unnecessary intermediaries and artificial obstruction in interstate trade.

In the services sector, service providers were allowed to take a credit for service tax paid on inputs but could not use that credit if their clients were located elsewhere in other states and registered under the VAT regime at state-level. This discrepancy resulted in wasted credits and an increased cost of doing so. Small businesses especially suffered from these inefficiencies due to their lack of financial resources and technology to handle multiple tax systems.

There was a trickle-down of several negative effects:

Cost of goods and services up, making Indian products less competitive in international markets.

• The distortion of production and distribution choices as businesses focused on tax avoidance rather than logistics or efficiency.

• Opacity, as the ultimate purchaser of these systems saw no tax burden.

Advertisement • Restricted input tax credit that led to the breaking of tax chain and non-compliance.

Consequently, a lack of consolidated credit mechanism among various taxes acted as a bottleneck to economic efficiency and transparency. This had necessitated that businesses perform complicated tax planning and frequently absorb the tax cost themselves, a diminution of their profit margin. The introduction of GST was supposed to resolve this core issue by providing for a porous input tax credit across goods and services based as it is on central and state levies.

8.3.3 Key Reforms Brought by GST

One Nation One Tax (World's largest experiment of this!) Implemented with the vision to make India a modern, efficient tax system. It introduced various revolutionary changes wherein the old multi-tax system was replaced by a single, unified system of taxation that encourages transparency, compliance and financial growth. These changes rectified the pre-GST's inefficiencies and anomalies to a great extent, expediting the process of doing business in India.

The significant reform included doing away with existing multiple taxes and introducing a single GST regime covering central levies such as excise duty, services tax and CVD, and state taxes like VAT, entry tax, luxury tax and entertainment tax. This consolidation streamlined reporting, minimized the need to file returns and resolved overlap by multiple taxing bodies.

Among other significant reforms was the introduction of ITC under all goods and services, which means that from petroleum to restaurant bills, the businesses can claim a credit for taxes paid on inputs even if it is good or service. This put an end to the cascade and also ensured tax was not charged on value addition at each stage. For example, if your company's sales have stalled, you are more likely to be able to take credit for your office rent or for the furniture in it than you were under the old system.

GST also switched to a destination-based tax regime, so that the revenue flows into the state of consumption and not in the state where the goods are produced. This also helped eliminate the distortion by CST and encouraged better inter-state trade and distribution systems.

The formation of the GST Council was another significant institutional change. It includes members from the central and state governments, and recommends rates of tax, exemptions and procedural rules. This leads to cooperative federalism and allows states to maintain fiscal autonomy whilst contributing to a common tax system.

Another feature of GST is compliance driven by technology. Digitization of the entire process vis-a-vis registration, return filing, payment and refunds etc which was not prevalent earlier through the strategic rollout GSTN of Goods and Services Tax Network (GSTN) has improved transparency and accountability. Since every transaction is recorded electronically, tax evasion has been more difficult and data-driven decision-making has improved.

Other reforms are the e-way bill mechanism to keep a tab on movement of goods, anti-profiteering measures to ensure that companies pass on benefits of input tax credit to consumers, and the composition scheme for small businesses making it easier for them to comply with the new regime.

The reforms, intended to be taken together, are all part of an agenda aimed at providing a common economic area in India, increasing tax collection by better compliance and helping to make the country more competitive by reducing costs and increasing economic integration. The system is dynamic, and there are refinements done on ongoing basis to resolve issues

faced by stakeholders, however the paradigm shift ushered in by GST has been one of the major indirect tax reforms in India ever.

8.3.4 Compliance, Filing, and Transparency Under GST

One of the most transformative reforms brought in with GST was complete revamp of compliance mechanism. Before GST, compliance was complex with the existence of multiple taxes, separate laws and different filing systems for central and state shares. Businesses had to file multiple returns with different tax departments, keep separate records for VAT filings, service tax and for excise duty and the audit norms were quite contrasting. The GST system, on the other hand, ushered in with it a single digital compliance mechanism to ensure transparency and simplify filing— This was also intended to curb under-reporting.

The nucleus for all GST compliances is the Goods and Service Tax Network (GSTN), which is a strong IT backbone designed to handle all compliance activities online. Registration, payment of taxes, matching of invoices, filing returns as well filing for refunds and grievance redressal can be done on the site. This digitisation has enforced greater moral responsibility of tax payers and eliminated the large human interface, which further reduces scope for corruption and discretionary action.

Under GST, businesses consult periodic returns that include the details of the sales and purchases along with Input Tax Credit (ITC) claim and tax liability. The major categories of returns are GSTR-1 for transactions OUT, GSTR-3B for payment of tax and filing summary return, and GSTR-9 for annual returns. Returns are shown linked with auto-populated options, enabling the invoice-matching process which makes sure that a buyer claims input tax credit only if the seller has reported the sales. This mechanism has led to a good level of transparency in tax reporting and curbed issuance of fake invoices or over-claiming of input credit.

Also, under e-invoicing for large entities (and soon to be extended for smaller ones), all invoices are posted on the GSTN portal real-time and validated. This will increase compliance verification, reduce the burden of return preparation and also enhance the credibility of tax invoices.

GST has ushered in the e-way bill system, a national-level electronic permit for movement of goods beyond a value limit. It has helped arrest tax loss during the transit and enhance logistics efficiency as well as abolished multiple border check-posts, reduced transit time and cost of transport.

The compliance mechanism incorporates elements of self-assessment and audit/examination by the tax authority, so that there is an equilibrium between trust-based regulation (in terms of governance) on the one hand, and rule -based regulation (from a regulatory perspective)

by the government on the other. Taxpayers are urged to voluntarily disclose liabilities and set off credits only in future, if need be.

As regards transparency, GST has instituted a system in which every transaction is traceable, verifiable and auditable. It has raised confidence in relation to stakeholders and investors. Thanks to analytics and data mining, authorities can now more efficiently discover mismatches, tax evasion or under-reporting.

That compliance system has not been without its teething troubles, however. "Frequent changes in the return formats, technical glitches on the GSTN portal and difficulties in reconciling GSTR-2A/2B with purchase records have been a challenge more so for SMEs. The sheer volume of filing returns remains an immense burden for many businesses and nobody wants to see the figures return to those levels.

Still, GST has developed a good platform for an honest and IT-driven tax administration system to ensure honest trade practices among businesses as well as maximising the government revenue without increasing tax rates.

Did You Know?

"GST compliance in India is almost entirely digital—one of the largest such systems globally—covering over 1.3 crore taxpayers. From registration to return filing and refund processing, all key processes are carried out online through the GSTN, significantly reducing paperwork and enhancing real-time monitoring."

8.3.5 Challenges and Criticisms in the Transition to GST

It was a bold reform to simplify the indirect tax system and bring about uniformity that posed several logistical nightmare when it was rolled out. The daunting size of the reform agenda, coupled with India's complex federal arrangement and diverse stakeholders meant the transition was a challenge for businesses as well as tax authorities in many instances.

The preparedness of businesses especially the SMEs, for technology during the transition was one of the key issues. The exclusive dependence on digital end-to-end process of registration, invoicing, return filing and payment assumed a high level of IT skills, reliable access to the internet and integration with systems. Small business in semi-urban and rural areas was not geared to change that model overnight, which led to the non-compliance levels and skepticism on penal provisions.

The GSTN site, the epicentre of all compliances faced inordinate technical issues during the initial months after its launch. Return filings would timeout, invoices wouldn't load correctly, reconciliation errors were frequent. The resulting confusion and taxpayer frustration also prompted the government to extend several filing deadlines. The continuous changes in schedules and notifications piled up the compliance fatigue with no space for companies to act.

Another perpetuation was the over-complex tax structure. India deviated from the original concept of a single GST slab system and instead adopted a multi-slab rate structure featuring four principal rates (5%, 12%, 18% and 28%), apart from cess on certain goods. This resulted in classification wrangling, the confusion of rates and the lobbying for rate depressions. Companies that sold goods across a variety of product categories had difficulty applying the proper rates, and disparities in how states interpreted the ruling created confusion.

Working capital squeeze was the other large issue, especially for exporters and cases of inverted duty structure (when tax on inputs is higher than outputs) where refunds were getting delayed. Several exporters saw severe cash flow squeezed, as refund disbursal was slower than anticipated, vowed to be a seamless fast-track exercise under the GS.T.

There was also a lot of complaints around the burden of compliance. While the system was designed to alleviate a burden on compliance, for many small businesses it meant more administration, return filings and support from professionals as a part of their regular business requirements. This was quite challenging for micro-enterprises in unorganised sectors.

From a policy perspective, there were also critics who said the tax burden would be destabilised by constant rate and notification changes. Lack of predictability made it difficult for businesses to plan inventory, pricing, contracts. Subsequently, the anti-profiteering mechanism drove a wedge between the industry and the government, with companies not being sure of what would be considered passing of benefits that had accrued from getting input tax credit.

But despite the challenges, we must recognise that GST was one of the most ambitious reforms to have been tried in independent India. The transition involved balancing the interests of 29 states, multiple Union Territories and a host of industries — not to mention millions of taxpayers. The government had announced various measures to facilitate filing but deferring deadlines, rationalizing rates, launching the composition scheme for small taxpayers and simplifying return formats.

To sum up, the GST transformation was not perfect but it has paved the way for a single streamlined tax system. It has been ongoing feedback with policy flexibility and stakeholder engagement that have contributed to early smooth transition challenges, and future reforms will likely continue the stabilization of the system.

8.4 Summary

- GST (Goods and Services Tax) is an indirect tax that was introduced to replace all other indirect taxes in India.
- Its methodology is a destination based value-added tax, where tax is collected from point of creation to point of sale.
- It replaced central taxes such as excise duty, and service tax, VAT, entry tax, and entertainment tax levied by states.
- GST -It is a dual model structure with 2 components and can also be of four types : CGST, SGST, IGST and UTGST.
- "Supply" is the taxable event under GST and is a broad term covering all form of supplies made for consideration.
- ITC under GST is the relief from taxes an organization gets on paying taxes for inputs.
- The GST system is 100 per cent digital, from registration to return filing, and the GSTN portal provides all can be accessed online.
- One of the biggest hurdles before introduction of GST was cascading tax effect, which led to an increase in the final price of goods for consumers.
- Under the GST, major inefficiencies of the previous system were corrected and compliance enhanced with invoice matching and e-invoicing.
- We have first faced challenges like technology and rates complexities but GST is evolving more for better.
- One, the GST Council, is a constitutional body that deals with rates and compliance policies and improvements in systems.
- GST improves transparency and promotes inter-state trade, seeks to reduce the overall tax environment across businesses.

8.5 Key Terms

1. GST (Goods and Service Tax) – It's a single tax on the supply of goods and services all over India Snippet

2. CGST – Central Goods and Services Tax payable to the central government for Intra-State transactions.
3. SGST – State Goods and Services Tax charged by state government against intra-state transactions.
4. IGST – Integrated Goods and Services Tax for interstate sale or purchase by the Central Government.
5. UTGST –Union Territory GST charged in Union Territories instead of SGST.
6. Input Tax Credit (ITC) -Tax paid on purchases to be deducted from output tax.
7. Supply – Taxable event under GST which includes sale, transfer, exchange, barter, lease or disposal.

8. GSTN – Goods and Services Tax Network, the online platform for compliance and administration of GST.
9. GST Council – A body conceived as a Constitutional authority to recommend tax rates, exemptions and the features of GST.
10. E-way Bill – It is an electronic permit issued for movement of goods of specific value.
11. Composite Supply – A supply comprising two or more taxable supplies, one of which is a principal supply.
12. Mixed Supply – a set of independent products or services that are marketed collectively, but are not typically available as such.

8.6 Descriptive Questions

1. Discuss the salient feature of the pre-GST regime of indirect taxes and explain some problems that were associated with this part?
2. What is the tax cascading effect? How does GST eliminate this problem?
3. Explain the types of GST in India and how they operate with respect to intra-state and inter-state supply.
4. What are the key changes in taxation system for India after introduction of GST?
5. What is the meaning of "supply" in GST? Why is it referred to as the lynchpin of the GST structure?
6. Discuss the input tax credit system vis-à-vis GST. What can it do and not do?
7. Explain the significance of GSTN in bringing transparency & increasing tax compliance in India.
8. Enumerate the major challenges and criticisms encountered during the shifting from old tax system to GST.

8.7 References

1. Central Goods and Services Tax Act, 2017
2. Constitution (101st Amendment) Act, 2016
3. Ministry of Finance, Government of India – GST Overview and Reports
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5. Reports of the GST Council and Parliamentary Committees on GST
6. Economic Survey of India – Chapter on Indirect Taxation Reforms

Answers to Knowledge Check

Knowledge Check 1

1. c) Destination-based tax
2. b) Import & export
3. c) All commercial transfers
4. c) Goods/services are received
5. c) Union Territories

8.8 Case Study

“Goods and Services Tax (GST) 1.0 What is Goods and Service Tax (GST)? Ltd."

Background

Arya Electronics Pvt. Ltd., a medium-sized company in Ahmedabad, that makes and sells consumer electronics including LED TVs, washing machines and sound systems. Before 2017 GST, your organization might have been doing businesses under the legacy indirect tax regime where you had to deal with excise duty, VAT, CST and service tax separately. With its operations spread over a number of states across India, the company had to deal with high compliance costs, input credits getting blocked and challenges in moving goods from one state to another.

Post-GST Transition

Arya Electronic had to shift to GST after the system was implemented. The business then made extensive modifications, such as updating its software and training staff members and reorganizing accounting flows. “While GST did away with a lot of other things, it brought about e-way bill and monthly filing and invoice matching, all of which were new compliance requirements that took everyone time to get used to in the beginning leading new challenges in terms of cash flows.

Problem Statements

Non-compliance by vendor leading to loss of Input Tax Credit

Arya Electronics found out that a significant amount of its input tax credit was not available on the GSTR-2B form, as a few suppliers didn’t upload invoices or file GSTR-1 on time.

Working Capital Pressures resulting from Delay in Refunds:

The company sells some of its product overseas. While GST had ensured faster refunds on zero ratings supplies, in Arya's case refund amounts got stuck for a couple of months which led to cash flow issue.

Complex Classification of Products

GST in various slabs on goods and services. It was the newer types of multi-functional electronics that caused Arya some confusion — to the extent he and vendors were at odds with tax authorities about which prices should apply.

Solutions Implemented

For Vendor Compliance and or ITC Matching

This involved a rigorous vendor selection and qualification process in which the vendors were given rating based on their compliance history. Purchase orders were reworded to stipulate penalties for rejection of the order. To counteract this, the company also started employing tax-parsing software which reconciled purchase invoices with GSTR-2B.

For Working Capital Management And Refunds

Arya hired a specialised tax team to track the refund applications along with documentation and frequent follow-ups on the GST portal and tax officers. They also moved to monthly refund applications from quarterly, with an objective of faster fund inflow. Alternate funding facilities were also obtained on a short-term basis for working capital needs.

For Product Classification Issues

The company appointed a GST consultant to file the advance ruling applications for several products where tax rates were in dispute. Teams were also trained to study the classifications under HSN code before launching new models. A single tax code master database was created and integrated with the ERP to maintain rate uniformity.

Reflective Questions

1. What was the impact of GST's dependency on vendor compliance on input tax credit process for Arya Electronics?
2. What is the impact of delayed GST refunds on the working capital of exporters?
3. What is the importance of classifying a product correctly under GST and what can happen if it is classified incorrectly?
4. To what extent is internal automation helpful in effectively dealing with GST compliance?
5. How can companies balance their compliance needs and operating flexibility with GST?

Conclusion

Arya Electronics' case also throws up the hardships that businesses may face while shifting to the new tax regime. GST though has simplified the tax system, it requires a high level of tech-readiness and compliances accuracy as well as regular exchange of reconciliations with your

vendors. Discipline like digitization, professional advisory, vendor management and process restructuring need be part of the proactive approach if business is to maximize benefits derived from the GST regime. The journey of Arya Electronics is such which demonstrates how while GST promises a bright future in the long run for the country yet it needs consistent flexibility and process discipline to be followed.

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Unit 9 Registration under GST & Types

Learning Objectives

1. To explain the concept and importance of registration under the Goods and Services Tax (GST) system.
2. To identify the categories of persons and businesses required to obtain GST registration.
3. To analyze the threshold limits for GST registration and their applicability across different states and sectors.
4. To distinguish between the different types of GST registration such as regular, casual, non-resident, and composition schemes.
5. To describe the step-by-step procedure involved in obtaining GST registration online.
6. To evaluate the benefits and obligations arising from GST registration for businesses.
7. Comparing voluntary and mandatory GST registration and assess their implications for business operations.
8. To understand the consequences of non-registration or delayed registration under GST law.

Content

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9.2 Types of GST Registrations
9.3 Registration Procedure and Compliance
9.4 Summary
9.5 Key Terms
9.6 Descriptive Questions
9.7 References
9.8 Case Study

9.0 Introductory Caselet

“The Dilemma of FreshStart Enterprises: Choosing the Right GST Registration”

FreshStart Enterprises – a start-up venture co-founded by Mr. Arjun Sharma, has been established with the vision to trade home appliances like refrigerators, washing machine and small kitchen tools. At first, the operation was confined to one district in Uttar Pradesh with meager sales. Since the sale was less than a fixed cutoff of ₹40 lakhs, Mr Sharma didn’t register with GST, at that time considering it to be redundant.

But two years later, the company had significantly expanded. FreshStart Enterprises found three additional states and started selling over the internet on e-commerce sites. The firm's turnover thus crossed the cut off of Rs.20 lacs for registration under GST. With this expansion, Mr. Sharma knew that obtaining the GST registration was no more an option but became a compulsion to be registered under the Act.

While he was studying the registration process, he found that there are various types of registrations under GST:

• Normal GST Registration: Applicable to businesses making taxable supply throughout India.

• Composition scheme: It is applicable to small taxpayers with low turnover which not only allows simplified tax payment but has restriction on inter-state trade and input tax credit.

• Casual Taxable Person (CTP) Registration: required for businesses which operate on occasional basis such as in fairs, exhibition and event.

• Non-Resident Taxable Person Registration: This will apply to foreign entities offering goods or services in India but having no fixed place of business.

• Optional Registration: This can be for those under the threshold where voluntary compliance and credit/invoice benefits can be availed.

Mr. Sharma is now at an inflection point. On the other hand, though Composition Scheme offers lower compliance burden, it is not conducive for inter-state and e-commerce business. Regular GST Registration, on the other hand, facilitates full participation in interstate trade and claims of input tax credit but it incurs more compliance costs.

FreshStart Enterprises has a decision to make that accommodates its present business practices (multi-state organization and online sales) and set for the future growth (name recognition contiguously).

Critical Thinking Question:

If you were the GST advisor to FreshStart Enterprises, what kinds of GST registration would you suggest and why? HIGHLIGHT IN YOUR RESPONSE THE BALANCE OF COMPLIANCE, COSTS AND OPPORTUNITIES FOR GROWTH.

9.1 Eligibility Criteria for GST Registration

The introduction of Goods and Services Tax (GST) in India was a historic reform in the indirect tax structure. GST Registration is the first and foremost step for a business to become a genuine part of the GST system. It is not just to cover the authorities' world of with-holding tax on outward supplies, charging and collecting it from customers while being eligible for credit when paying taxes due on inputs. Eligibility for registration under GST is regulated by statutory provisions, notifications and rules that together specify who needs to register, who can choose to apply for registration voluntarily and who is not required to be registered. These are provided mainly in section 22 (persons liable for registration) and section 24(Compulsory Registration) of Central Goods and Services Tax Act, 2017. Furthermore, state-wise threshold limits; voluntary registration options and exemptions provide a structured framework ensuring revenue neutrality-potential vs ease of doing business.

9.1.1 Persons Liable for Registration [Section 22]

Section 22 is the basic section of GST registration. It provides that every supplier shall be liable to be registered where his aggregate turnover in a financial year exceeds such threshold. This provision is generally applicable to all persons, partnerships, or corporations engaged in supplying goods or services.

The definition of ‘person’ in the term GST is extensive. It includes:

• Businesses owned and/or operating in the name of individual(s).

• Hindu Undivided Families (HUFs)Doing business in joint names of family members.

• Partnership firms and LLPs including such organisations whether registered or not.

• Companies (public, private, or government-owned).

• Societies, AOP (Associations of Persons), and Trusts carrying on business.

• Organizations of state or municipality in providing taxable goods or services.

• Artificial Judicial Person like cooperative societies and clubs.

liability is turnover based and the definition of aggregate turnover is wide to ensure that there are no loopholes. Aggregate turnover Provide: Aggregate turnover shall be considered to include all supplies such as the taxable supply, exempt supply, export of goods or service or both and inter-state supply. But it does not include taxes such as CGST, SGST, IGST and cess. For instance, a dealer in Maharashtra, who sells taxable goods worth

₹35lakhs and is also dealing in exempted goods of ₹10 lakhs which totals to ₹45 lakhs will have to be registered under GST.

Another important characteristic of Section 22 is also innovation in business structure. Registration by the transferee from the date of transfer will be required in case of transfer of business as a going concern for maintaining continuity of tax. (1A) Where a company has been the resultant of a merger or demerger, as approved by any scheme made under the Companies Act, or amalgamation by order of High Court and if the Registrar is satisfied that it is essential to cancel(n)f 2[nfauthority so given].

In other words, Section 22 establishes a turnover-based threshold for liability and simultaneously ensures that every kind of business entity is required to come within the tax net once it attains such size as should entitle a Government to require compliance from it.

9.1.2 Mandatory Registration under Certain Cases [Section 24]

Section 24 goes beyond turnover. But it demands registration in certain cases when there is a high risk of tax leakage or degree of surveillance necessary. This is a non-obstante provision over Section 22 – which means registration becomes mandatory, even if the turnover is lesser than prescribed by the GOI.

The sections of 24 are following, football clubs:

• Inter-State Supplies: All suppliers making inter-state taxable supplies need to register. For example, if a Delhi-based seller is selling to customers in Haryana, he must register irrespective of the turnover. While some later amendments offered relief to service providers, good supply is fully shielded.

• Casual Taxable Persons: Entities that supply goods or services without a fixed place of business in a state must register when they occasionally conduct business in the state. Like a jeweller from Rajasthan who opens up shop only for the duration of a trade fair in Gujarat.

• Non-Resident Taxable Persons: Some foreign companies are required to register before supplying taxable goods or services in India. This is because it brings OCI within the Indian net while ensuring that foreign suppliers also become part of the Indian tax base.

• Agents Supplying on Another's Behalf: If you are a person supplying goods as agent for another person, e.g. consignment agents, brokers, auctioneers etc., you must register. This makes indirect deals into transparent ones.

• E-commerce entities and aggregators: Online marketplaces or services aggregators (such as taxi-hailing or food delivery apps) are required to mandatorily register. Sellers who utilize e-commerce platforms may also be required to register (depending on the way of doing business).

• ISD : A Head office receiving tax credit on input services and distributing the same to its branches.

• Persons liable to pay tax in Reverse Charge: Even if the turnover is less than the threshold limit, persons who need to pay tax under reverse charge are required to be registered.

Para 24 points to the forward-looking spirit of the GST law in including varied modes of trading under its tax scope. The focus toward inter-state trade, e-commerce and intermediaries shows that the government aims to reduce revenue leakage and have an effective tax administration in place.

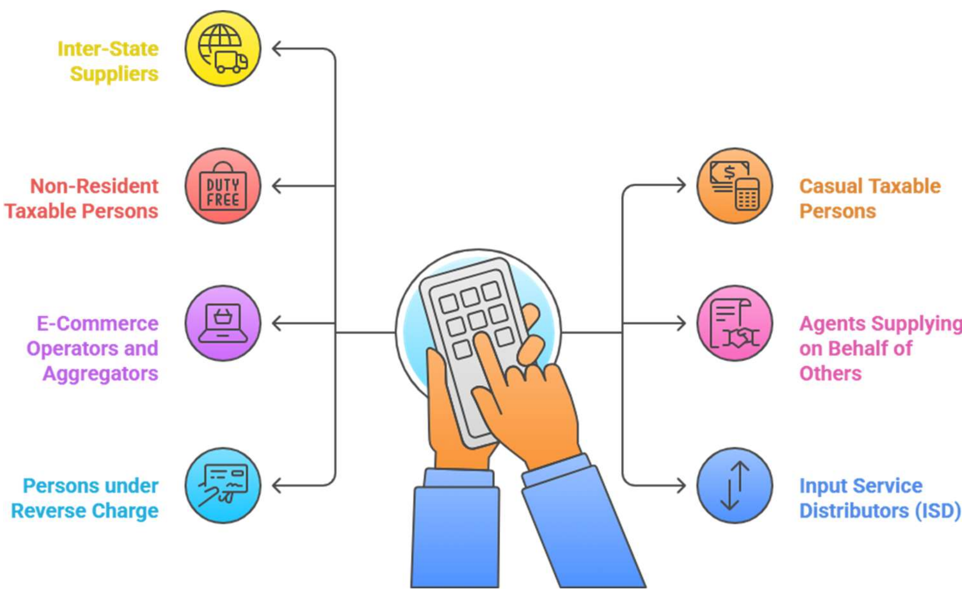

Figure 9.1

9.1.3 Threshold Limits for Goods and Services (State-Wise Variation)

Threshold limits play a significant role in deciding the liability under Section 22. They differ depending on whether they are goods or services and also by the state in which the business operates.

The threshold of 40 lakhs are for goods, with some exceptions In most states, the GST registration is mandatory if an entity crosses ₹40 lakhs aggregate turnover. In the case of services, it is ₹20 lakhs. However, for special category states (which includes Arunachal Pradesh, Mizoram, Manipur, Meghalaya, Nagaland, Sikkim, Tripura and Uttarakhand), there is a lower limit of ₹20 lakhs for goods & ₹10 lakhs for services.

This variant reflects the diversity of India's economic structure. The less affluent and hilly states in the northeast are provided with lower limits to provide for their inclusion in the GST system at an early stage.

A few additional notes on threshold limits are:

• State' option to adopt threshold: States are provided an option to go for ₹20 lakh threshold in place of ₹40 lakhs, considering the revenue consideration.

• Goods and Services Considerations Separately: Businesses which buy and sell will have to look at their turnover separately under the two limits.

• Multistate Application: A business with operations in more than one state will need to satisfy the threshold requirements in each separate state. Clicking the threshold in one state will subject you to registration in that state.

• Period for Registration: After the turnover limit has been crossed, the person is required to take registration within a span of 30 days.

This two threshold system, therefore, represents a compromise between uniformity and flexibility that allows states to design compliance appetites according to their level of economic development while ensuring coverage of GST at the national level.

9.1.4 Voluntary Registration and Its Implications

It is important to note that the GST system provides for voluntary registration and businesses operating below the threshold can choose to register, if they see it as being beneficial from a strategic perspective. This section recognizes that registration might provide benefits other than compliance.

The advantages of voluntary registration are:

• ITC (Input Tax Credit) benefit – It ultimately reduces the tax cost of goods and services thereby helping businesses to become more competitive, profitability.

• High Market Reputation &Trust: A business that is registered under GST is seen by its buyers, customers as committed and trustworthy.

• Access to B2B markets: Larger corporates and government bodies prefer to conduct transactions with sellers that are registered under GST so as maintain smooth credit flow.

• Cross state selling: You can trade across states even if you are selling through e-commerce platforms., through voluntary registration.

• Future proofing: Startups and small businesses that expect to scale can begin with compliance in mind, which will accommodate future growth.

But voluntary registration has obligations:

• Compulsory Compliance: Persons who are registered will have to file returns at periodic intervals and maintain their accounts under the GST regularly, depositing collected tax within time limits.

• Bureaucracy / Administrative costs: Small businesses may need to comply with more complex accounting, filing, and professional fees.

• Cash flow impact: Businesses are required to charge and then pay GST on their supplies, potentially impacting their cash flow.

Hence, voluntary registration is a strategic compromise. For some, it could unlock new markets and drive efficiency; for others, it might simply impose compliance costs. It is up to the businesses whether it will be more beneficial than burdensome before choosing it.

9.1.5 Exemptions from Registration

GST legislation also provides that some persons or businesses should not have to register if they are very small, socially significant or make particular supplies. Exclusions are therefore a crucial component of the registration system.

Special classes that are excluded from registration :

• Suppliers of Exempted Goods or Services: Individuals making only exempt supplies (like agriculture products, health & education services) are not required to register. As they are tax-free sectors, registration will not have any significance.

• Agriculturalists: Farmers producing and selling from cultivation of land are exempted to be in line with the agricultural economy that country relies so heavily on.

• Small Service Providers: Small service providers, whose turnover is within the limits as specified in the respective state laws or rules made thereunder for any of the categories of registration mentioned above shall not be required to obtain registration either.

• Persons making supplies only to persons paying tax on its RCM advocates – Persons receiving products and services for payment of tax under reverse charge are not required to register unless they make taxable supply some other way.

• Government Notified Exemptions: The government can notify exemptions for certain businesses or industries from time to time.

Exemption :The purpose of the exemption is two-fold: to minimize the compliance burden on small and significant social sectors business, and also to mitigate unwarranted administrative costs for tax authorities.

"Activity: Evaluating GST Registration in Practical Scenarios"

In this activity, learners will be given detailed real-life scenarios to analyze. For example, a retail shop in Assam with turnover of ₹18 lakhs, a freelance designer in Delhi earning ₹12 lakhs annually, a farmer in Punjab selling wheat produce worth ₹25 lakhs, an e-commerce seller in Mumbai supplying goods nationwide with turnover of ₹10 lakhs, and a multinational company establishing its first branch office in India. For each case, students must decide whether GST registration is required under Section 22 or Section 24, identify applicable threshold limits, and consider whether voluntary registration may be beneficial. They must also justify their answers with reasoning, citing provisions of the Act and practical implications. This activity enables students to apply statutory knowledge to real-world circumstances, building their ability to critically analyze compliance obligations.

9.2 Types of GST Registrations

All sizes of businesses having different nature and geographic presence is acknowledged by the Indian GST system. One type of registration cannot adequately meet the needs/requirements of all taxpayers. Therefore, the GST law provides four or five categories of registration depending on sector: normal businesses, small suppliers, temporary supplies (valid for 90 days), foreign-supplied goods and services or special entities like the embassies and UN bodies. Each registration type has different eligibility criteria, compliance responsibilities and implications on the businesses. Some of the broad categories are Regular Registration, Composition Scheme, Casual Taxable Person Registration, Non-Resident Taxable Person Registration and UIN (Unique Identification Number) registration for the special purposes.

9.2.1 Regular Registration

Ordinary registration is the general and basic type of registration for GST. It covers all businesses who make taxable supplies of goods or services above a certain turnover level or if they are required to be registered under specific categories. A business that chooses to register under common portal gets a Goods and Services Tax Identification Number (GSTIN), i.e., the unique number of legal entity within GST, as distinct identity.

The procedure for regular registration requires online application through the GST.GOV.IN, physical submission of PAN, AADHAAR proof that is business place/provisional bank account., which in turn would be approved by the concerned tax officials. After approval, the applicant gets GSTIN and then compliance starts.

Compliance Obligations under Regular Registration:

• Filing of Returns:

Registered taxpayers are required to file periodic return (GSTR-1, GSTR-3B) and annual return. This is an apt thing for reporting of sales, purchases, tax liability and input tax credit. Failure to submit results in late fees, penalties and in some instances, a suspension of the registration.

• Issuance of Invoices:

Any registered business is mandated to provide the tax invoice that should include particulars such as GSTIN, invoice number, HSN/SAC codes, tax rate and amount of taxes. This helps standardise transactions and makes sure that both buyers and sellers are adhering to the law.

• Input Tax Credit (ITC):

Common registrants may take ITC of the GST paid that were used for business on inputs, input services and capital goods. This minimizes gross taxation and provides a fair and transparent system for businesses.

• Record Maintenance:

Books of account, invoices, credit/debit notes and stock registers should be kept for a period of not less than six years. This is helpful for tax inspectors during audit and makes it possible to trace payments.

Advantages of Regular Registration:

• National Trade Capability:

Under the regular registration system, businesses are allowed to engage in inter-state trade, supply goods via online e-commerce platform or export their products within and without the state enabling them access a larger markets and more customers with no legal fettering.

• Credibility Enhancement:

Businesses are usually discerning when engaging other businesses and, in addition to a reduction of risk (of future litigation) if the other party defaults on the agreement, they feel much more reassured that you are ticking all your regulatory boxes.

• Access to ITC:

The effective tax rate goes down for business by the mechanism of input tax credit rendering it more profitable. This has made them more competitive that unregistered suppliers.

Normal registration, is beyond any shades of doubt, a lifeblood for GST compliance. It means government revenue is guaranteed, companies have a stamp of approval to do business and top-soil is protected from plundering in the name of commerce.

9.2.2 Composition Scheme [Section 10] – Eligibility and Conditions

Section 10 of the CGST Act provides for a composition scheme to facilitate smooth compliance from small taxpayers. It enables seamless compliance by enabling eligible businesses to pay tax as a fixed percentage of turnover, instead of at the regular GST rates. This is especially advantageous for smaller traders and manufacturers which do not have the organizational set-up to deal with sophisticated compliance.

The following are the eligibility criteria for taking this Composition Scheme:

• Turnover Limit:

Businesses having a previous year aggregate turnover of up to ₹1.5 crore (₹75 lakhs in case of special category states) are eligible for availing the composition scheme. And this means only small taxpayers can make hay.

• Types of Businesses Allowed:

The government has also introduced the scheme for manufacturers (except those who are manufacturing notified goods), dealers of goods and restaurants that do not serve alcohol. It doesn't cover service providers, although a series of later amendments permitted certain types of services.

• Restricted Activities:

It also does not apply on inter-state supplies, those made through e-commerce operators or manufacture of entities notified under mission such as ice cream, pan masala and tobacco. 4 Did this too, inorder that the one who would abuse the system would be larger.

Conditions of the Scheme:

• Tax Rates:

Composition tax rate is for trader 1% on turnover, manufacturer @ 2%, restaurateurs@5 Share of revenue which Centre Govt. should Receive: 12711 (in Rs.) What Entrepreneurs should do? These rates are below standard GST rates but without input tax credit.

• Invoice Format:

Composition dealers cannot raise tax invoices with GST. Instead, they furnish “Bill of Supply” and cannot pass on GST to customers separately.

• Restriction on ITC:

No Input Tax Credit is available in this scheme as it is facilitative and not credit-linked.

Advantages of the Composition Scheme:

• Simplified Compliance:

Dealers file returns on a quarterly, rather than monthly, basis to lessen administrative load. This allows time for smaller businesses to concentrate on growing their enterprises — not filling out paperwork.

• Lower Tax Liability:

It means fixed percentage tax you pay, which helps to keep the liabilities predictable – and also lower in many cases than regular rates.

• Encouragement to Formalize:

The scheme draws small merchants into the GST net, giving them legitimacy and the ability to integrate themselves into formal supply chains.

The composition scheme ensures that there is a compliance burden on small businesses keeping in mind their resource constraints both financial and manpower. It is most suitable for local traders, small manufacturers and restaurants working for local markets.

9.2.3 Casual Taxable Person – Meaning and Requirements

Meaning of Casual Taxable Person (CTP) CTP refers to a person who makes taxable supplies occasionally or inexcess as the referred case maybe, whether as principal, agent or in any other capacity, in a State/UT where he has no fixed place of business. The category was created to control impermanent business operations, such as trade fairs, exhibitions, seasonal sales and cultural events where providers go there to establish small booths or shops temporarily.

GST Registration is a pre-requisite for the provision of temporary supply by a CTP who intends to conduct business at the state where temporary supply is proposed. The registration is good for 90 days with a one-time renewal of another 90 days. A CTP is, unlike an ordinary registrant, required to make a prepayment of the value of HST at least equal to the estimated liability for the period of registration. This deposit is applied to the actual liability upon filing of return.

Essential Conditions for Non-Resident Taxable Persons:

• Advance Tax Payment:

A CTP is required to pre-pay the GST liability at the time of registration. This is done to prevent shortfall of revenue for government from temporary establishments.

• No Threshold Exemption:

Even though turnover is low; a CTP has to register under GST. Regular taxpayer threshold limits are not relevant here because of the fact that their business operation is temporary.

• Return Filing:

Similarly, CTPs are also required to file returns (GSTR-1 and GSTR-3B) in their registration period as regular tax paying persons for reporting of supplies.

• Limited Validity:

Registration is provisional and linked to a particular event or business operation. When the validity expires, the registration is automatically lapsed unless continued.

Implications for Businesses:

While CTP sign-up secures temporary supplier compliance with the requirements, it burdens them financially and administratively. A lot of small traders who sell at fairs or exhibitions find it difficult as they have to pay tax in advance, but it also brings them into the formal system.

Did You Know?

"Casual Taxable Persons cannot avail the benefit of threshold exemption under GST. Even if their supplies amount to just a few thousand rupees, they must register and comply with all requirements."

9.2.4 Non-Resident Taxable Person – Provisions and Compliance

Who is a Non-Resident Taxable Person (NRTP)? An NRTP is the one who does not have a permanent establishment in India and supplies taxable goods or services in India. This head caters to bring foreign firms engaged in temporary trading business with India, thereby bringing them within the purview of Indian taxation statutes and also ensure that they abide by the laws of India.

Enroll as an NRTP is mandatory before you start business in India. The registration is provisional, it lasts at most 90 days and can be renewed once. NRTPs, as CTPs, also must pay an advance tax of the anticipated amount due for that registration period.

Key Provisions for NRTPs:

• Advance Deposit Requirement:

Advance GST is to be paid by NRTPs on their estimated liability prior to registration. This shields government revenue when businesses leave after a few short engagements.

• Compulsory Registration:

Threshold limits do not apply. Even small transactions must be registered by NRTP Players, because cross-border transactions require to be fully followed.

• Filing Returns:

Periodic Returns- The NRTP is also required to file the periodic returns such as GSTR-1 and GSTR-3B in the period of registration.

• Taxability:

NRTPs will be required to meet all GST requirements including invoicing, paying and claiming input tax credits (to the extent that they are entitled in their business activities).

• No Permanent Establishment Required:

NRTPs do not need a branch office or fixed establishment, but they are required to adhere to the GST rules while carrying out their temporary activities.

This kind of registration keeps foreign suppliers in domestic competition on par with Indian suppliers and as a result offense/revenue leakage occurs and acts as a system promoter too.

9.2.5 UIN (Unique Identification Number) of Special Entities

The GST law also acknowledges the fact that there are some unique entities that hold place of business in India, such as diplomats missions, etc and whether these entities can be treated on par with normal taxable persons. For these bodies other than individuals, the GSTN is replaced with a Unique Identification Number (UIN).

Purpose of UIN:

The UIN structure is basically to track and refund of GST paid on purchase. Since diplomatic and international organizations are tax exempt by international treaties, they

do not have to pay GST in the long-term. But they get refund of the GST paid on their transactions as per the UIN system.

Entities Eligible for UIN:

• United Nations Specialised Agencies to include UNICEF, UNDP and WHO.

• Embassies and High Commissions of foreign countries in India.

• Honorary consulates and other paramount diplomatic missions eligible for international recognition.

• Such other Authority as may be notified by the Government from time to time.

Features of UIN Registration:

• Process:- The applicant who is eligible shall apply for a UIN online through the GSTN portal with documents and governmental authorizations.

• Refund Process: GST paid on inward supplies is refunded after the statements are filed.

No Tax Collection– Businesses with UIN, being not the regular taxpayer cannot collect GST on outward supplies.

• Tracking and Transparency: UIN is a distinct code for tracking, reconciliation and transparency of the refund process.

The UIN model honours international obligations and provides transparency within the tax administration function. It will allow diplomatic and international organizations to operate seamlessly in India without breaking the GST chain.

9.3 Registration Procedure and Compliance

Registration is the cornerstone of compliance under Goods and Services tax law. But, it is not just a business law that applies to particular businesses who comes under its ambit-limit and also includes the mechanism of transparency, tax accountability and recognition for b/usinesses in India. It is registration that allows a business to collect GST, claim ITC and on the other hand allow them to legally conduct inter-state trade. Without it, a business is out of compliance, and there are penalties. GST registration procedure is intricate as the application process is complex and involves use of prescribed forms (GST REG-01 to REG-06), attachments that are mandatory, making modifications in existing registrations where amendments may be essential and how cancellation or revocation can be applicable. Advertisement Also, the law also allows for more than one registrations by a state and multiple centres.

and imposes severe penalties on mis- or non-registration. Taken together, these provisions form a well-organized system of checks which would ensure the rigorous enforcement of GST with minimal revenue loss.

9.3.1 Application Process: GST REG-01 to REG-06

The methodology of registering for GST is a standardized and mostly an online process, which makes it quite fair and accessible. Application process of GST registration is quite straightforward, following the step-by-step procedure and forms to be filled in order to receive their respective unique identification number called a GSTIN. GSTIN becomes a unique legal identity of a registered business in the GST network.

The order of these forms is intended to provide clarity, communication and accountability:

• GST REG-01 (Application for Registration):

This is the application with which applicants begin the registration process. It captures information including, name of applicant, business PAN, Aadhaar details, address of the principal place of business, details of bank account and type of business entity. All supportive documents (such as identification, written evidence of when the applicant's surname was changed to acknowledge a change in marital status or a court order for an individual who is incorporating) must be uploaded here. It consists of Part A (general information) and Part B (specific business information).

• GST REG-02 (Acknowledgement):

When REG-01 is accepted, a response in the form of REG-02 will be sent. It has an Application Reference Number (ARN) which is a unique number that helps the applicant to track his credentials at every stage.

• GST REG-03 (Notice for Clarification):

When there are inconsistencies or further documents needed in the application, a notice in REG-03 will be sent by the reviewing officer. The effect of this is to bring matters to the notice of the applicants and allow them a chance to explain.

• GST REG-04 (Response to Clarification):

Respondents to REG-03 shall reply to it with its counterpart, REG-04 within the time set forth. This is the form to pass along missing documentation, explanations or amendments. A fast and appropriate response avoids refusal, and quickens the process of acceptation.

• GST REG-05 (Rejection of Application):

Should the officer not be satisfied with either application or response, then REG-05 is sent which refuses the registration. Grounds for rejection are given and may be rectified with the possibility of re-applying.

• GST REG-06 (Certificate of Registration):

REG-06 is the certificate of registration upon approval. It comprises the GSTIN, the name of business as per law, trade name, principal place of business and the date of registration. This certificate provides legal sanctity for conducting business under GST.

With this structured form-based approach, GST can help to standardize some of the processes and thereby support accountability. Each step of the process is recorded, which helps minimize disputes or confusion and can speed along what has sometimes been a long slog.

9.3.2 Documents Required for Registration

The registration for GST is more than just a formal process, with extensive documentation being necessary to prove the legitimacy of the applicant and making sure that only real businesses are registered. The papers are different depending on the form of business entity which wishes to be registered.

• For Individuals and Sole Proprietors:

Documents requiredThe documents will comprise PAN card of the owner, aadhaar card, proof of business address (e.g. utility bills or rent agreement), recent passport-sized photograph and bank account details. All these papers together serve as identity, address and financial proof.

• For Partnership Firms and LLPs:

Partnership deed or certificate of incorporation, PAN cards of partners, Aadhaar details, proof premises, bank particulars, and authority letters for the designated partner would be needed. These are evidence that the partnership is properly constituted and organised.

• For Companies (Private, Public, Government-Owned):

Certificate of incorporation, company's PAN card, MOA and AOA, resolution by the board to authorise the signatories, identity proofs of directors and bank account details are needed. These papers confirm your legal status, authority, and financial structure.

• For Societies, Trusts, and NGOs:

Documents Required: Registration Certificate, Trustees PAN, Identity Proof(Any of Aadhar/Passport/Voter ID), Address Proof (any of Aadhar/Utility bill/Voter ID), Bank Details and Authorization documents. This way, also the non-commercial organizations can be adequately acknowledged.

• Proof of Business Premises:

Documents of ownership, lease/rent agreement, consent letter or recent electric/ gas bill etc. will be entertained for consideration as proof of premises. Fictitious or fraudulent addresses are not registrable on these documents.

• Bank Account Proof:

Copy of cancelled cheque / bank statement / passbook is compulsory. These documents will establish that the GSTIN is mapped to a valid bank account for payment of tax and its refunds.

It is the imposition of documentation that's too much, and it signals the importance given to authenticity and accountability in GST. It acts as a filter that blocks the misuse of registration by shell or fake companies.

9.3.3 Alteration, Cancellation and Revocation of Registration

It is often necessary to adjust registration information as business conditions change. In the same way, businesses may go out of business, necessitating cancellation of registration, or they may desire revocation if registration has been mistakenly cancelled.

• Amendments in Registration:

If a business' legal name, principal place of business, contact details, bank account or authorized signatory changes it is the responsibility of that business to provide revision information. Small updates can be auto updated, while large ones need an officer to say they are ok. Frequent updates help keep this accurate and minimize compliance headaches down the road.

• Cancellation of Registration:

Voluntary cancellation is possible for the taxpayer after it discontinues its business, when it falls under certain threshold limits or if the enterprise has been sold or transferred. Registrations can also be cancelled by officers, if returns are not filed, if there is misuse of GSTIN or if frauds are detected.

• Revocation of Cancellation

When an officer cancels a registration, taxpayers have 30 days to apply for revocation following the cancellation order. Revocation has restored the GSTIN of the taxpayer and now it is able to conduct business legally as like before.

• Suo Motu Cancellation:

Officers have the privilege of suo moto cancellation of registration, if they find continued failure to file returns, are found involved in issuing fake invoice or misuse of GSTIN. The businesses then must file for revocation citing appropriate reasons.

“These are provisions that do allow legitimate businesses to have flexibility, while also giving police very strong powers to deal with criminal misconduct. It balances compliance with enforcement.

9.3.4 Multiple Registrations for Multiple States

It is a dual tax, where the center and states both get to levy taxes. SGST being a state tax, separate registration is required for businesses operating in multiple states (since they need to collect SGST in every State). It guarantees that income is captured in the state where a product or service was produced.

• Requirement of State-Wise Registration:

In case the business is operating in multiple states then they are required to be registered for GST for each of these states. For instance, if a company has offices in Delhi, Gujarat and Karnataka, it will have to acquire three separates GSTINs.

• Distinct Person Concept:

All state-wise registrations are considered as “separate person”. “Supply” in relation to the two branches is inter- state and taxed under IGST, despite both being a part of the same business.

• Separate Compliance Obligations:

Independent compliances of return filing, tax payment and maintenance of records are mandated under each registration. This is more work but provides state-level accountability.

• Discretionary Multiple Registrations in One State:

If you are a huge organization with varied business verticals, then you can go for more than one registration in the same state. For instance, a conglomerate might separate its textile and IT services firms for ease of complying.

This is required to bring GST in line with destination-based tax and to provide the consuming states their legitimate share of revenue. However, companies will need to be ready for more compliance work and resources.

9.3.5 Penalties for Non-Registration and Late Registration

GST laws are devised in a way to levy harsh penalties if fail to register where necessary or delay registration. These are also mechanisms to prevent tax evasion and hold compliance in check.

• Penalty for non-registration:

If a business is subject to registration and does not register, it owes the tax due with interest. Besides, 10% penalty on the tax (Website Minimum Website Rs 10000) is levied.

• Penalty for Fraudulent Intent:

Where deliberate fraud is found by the authorities, the penalty can be 100% of the tax due. They are meretriciously charging people for frivolous issues and demanding money to prevent prosecutrix or imprisonment.

• Late Registration:

Where a business seeks registration after the deadline, it may have to pay tax from when liability arose and prior to registration, with interest. That leads to more cost of compliance and financial burden.

• Other Consequences of Non-Registration:

o Businesses cannot raise GST enabled invoices, eroding customer trust.

o They cannot take input tax credit any more, making it costlier.

o They can't sell online (via e-commerce) o They are prohibited from participating in interstate trade.

o continued non-compliance could result in blacklisting and other appropriate action.

It is by associating penalties with tax fallout as well as credibility loss, the GST law makes businesses register on time.

Knowledge Check 1

Choose the correct options:

1. Which form is issued as the GST registration certificate?

a) REG-01

b) REG-03

c) REG-05

d) REG-06

2. Which proof is mandatory to establish business premises?

a) Aadhaar card

b) Rent agreement

c) Bank statement

d) Passport

3. Which provision allows registration details to be updated?

a) Cancellation

b) Amendment

c) Revocation

d) Suo motu

4. In GST, branches in different states are treated as?

a) Partners

b) Agents

c) Distinct persons

d) Same person

5. Minimum penalty for failure to register when liable is?

a) ₹1,000

b) ₹5,000

c) ₹10,000

d) ₹25,000

9.4 Summary

- GST registration is the process of legally recognising a business as required to collect GST on goods and or services supplied by them and claim the input tax credit.
- Section 22 Presumption as to turnover impositions and Section 24 Compulsory Registration in certain cases.
- The threshold limits of registration differ state wise and also depends on the nature of supply (goods or services).
- Common type of registration, for all eligible entities is regular.

- The composition scheme makes compliance easier for small tax payers, with a turnover ceiling.
- When is casual taxable person required to take registration before making supply of goods or services in a state on temporary basis?
- Non-Resident Taxable person supplying goods or services in India also need to temporarily register themselves.
- Special bodies, embassies and UN organization are awarded with UIN number.
- Registration is on the basis of prescribed forms (REG-01 to REG-06) and supporting documents.
- Modifications, Cancellations and Withdrawals of Registration reflect business operation changes and compliance concerns.
- Businesses with pan-india operations should be registered in state wise.
- Penalties are also applicable if not registered, late registration or false registration.

9.5 Key Terms

1. GSTIN: A 15-digit Goods and Services Tax Identification Number to be given to registered businesses.
2. Aggregate Turnover: cumulative value of taxable supplies, exempt supplies, exports and inter-state supplies but not including GST & cess.
3. Composition Scheme: It is a simple and easy scheme under GST which may opt for small taxpayers with turnover less than a certain amount.
4. Casual Taxable Person: A person who occasionally deals with taxable supplies in a state where there is no fixed place of business.
5. Non-Resident Taxable Person (NRTP): A person or a business offering goods and services in India from outside the country who does not have a fixed place of business.
6. UIN (Unique Identification Number): Registration number provided to special registrants such as U.N. bodies and embassies for GST refunds.
7. REG-01: The application form for registration under GST.
8. REG-06: Registration Certificate under GST would be provided on the basis of this form.
9. 2[Loss of registration] due to revocation of cancellation: The procedure for restoring registration cancelled by the tax officer.
10. Distinct Person: The businesses registered in different states which are of the same entity will be considered as distinct persons under GST.
11. ITC (Input Tax Credit): The credit of GST (tax) paid on purchases which is available to set-off the tax liability on the output supplies.
12. Suo Motu Cancellation: Cancellation of registration by the tax authorities, without any application from the taxpayer due to non- compliance or fraud.

9.6 Descriptive Questions

1. Discuss the conditions to register under GST as per sections 22 and 24 of CGST Act.
2. Explain different types of GST registration in India with examples.
3. Explain the process for registration under GST and specify the significance of forms REG-01 to REG-06.
4. What are the documents required for GST Registration? Distinguish between needs for individuals, businesses and organisation.
5. Discuss the procedure and reason for cancellation, and revocation of GST registration.
6. Why is it necessary for a business to register in multiple states if that business does not operate across every state line? Discuss its implications.
7. Explain penalties on non-registration and late registration as per the GST law.
8. Discuss the importance of voluntary registration, and its pros and cons for small business.

9.7 References

1. Central Goods and Services Tax Act, 2017.
2. Integrated Goods and Services Tax Act, 2017.
3. Goods and Services Tax Rules, 2017.
4. Institute of Chartered Accountants of India (ICAI) – Study Material on GST.
5. Government of India Notifications and Circulars on GST.
6. Academic Textbooks on Indirect Taxation and GST Laws.

Answers to Knowledge Check

Knowledge Check 1

1. d) REG-06
2. b) Rent agreement
3. b) Amendment
4. c) Distinct persons
5. c) ₹10,000

9.8 Case Study

GST Registration Challenges Faced by BrightMart Retail Pvt.

Case Narrative

BrightMart Retail Pvt. Ltd., a Delhi based mid-sized corporate house, which took off in 2019 as an importing whole sellers of consumer electronics. The company was initially limited to Delhi, and had sales that were marginally above the threshold for registration under GST . It got itself registered as normal tax payer and acquired its GSTIN. The business grew rapidly, and the firm opened branches in Haryana, Maharashtra and Karnataka. With the extension, BrightMart raised issues on registration in several categories, compliance duties and administrative punishment for breaches of some obligations.

The management realized soon enough that the adherence to GST was not similar in all states. A separate GST registration was necessary for each branch, and supplies between states were classified as inter-state supplies—even where these took place between BrightMart's own branches. This created instances of IGST being levied on stock transfer, which confused the accounting procedure. In addition to the above, BrightMart also found difficulty in filing timely returns and maintaining records against every GSTIN, and frequently ended up missing such due dates that even resulted in Late Fees.

BrightMart also faced a challenge when it decided to exhibit at an annual electronics trade fair in Gujarat. Since there was no regular office of the company there, it was to register as a Casual Taxable Person (CTP), deposit advance tax and file returns on a temporary basis. The finance team was not happy as it was awkward and expensive to facilitate when the trade fair business didn't justify the compliance.

Problems also surfaced when the Karnataka branch of BrightMart, mistakenly late in registering for GST despite exceeding the turnover threshold only some months earlier. The revenue offered a penalty of interest plus a compulsory fine of 10 percent, to which he requested an instalment plan for the fine.

BrightMart also provided some products to an embassy in Delhi. As the embassy was not an ordinary taxpayer but possessed a UIN, BrightMart had to follow unique invoicing procedures and seek refund of taxes on purchases by the embassy. The sales team struggled to keep up with these trades and still attend to regular retail business.

Despite its success and growth, when it came to dealing with GST compliance, the company found that this meant they needed full-time resourcing on board, upgraded accounting systems and a strong understanding of procedures. These

difficulties emphasise the need for a 'better safe than sorry' approach when it comes to compliance and the perils of ignoring procedural requirements under the GST.

Problem Statements and Solutions

Issue 1: Multiple registration in various States was creating chaos and complexities for compliance of identity of such persons.

Answer: BrightMart must implement integrated accounting software that can manage

multiple GSTINs. Training personnel on GST compliance at each branch leads to prompt returns and precise tax payment.

Issue 2 — Temporary registration for exhibition as a CTP involved additional costs.

Answer: The company needs to weigh the pros and cons of participating in such fairs. "If business volume is very little then they may think of not participating or tying up with the local registered dealer and share compliance burden."

Issue 3: Penalty for delayed registration of Karnataka Branch adversely affected SEPZPL s profitability.

Solution: BrightMart needs to set up effective tracking systems for PCO turnover and IC control in the branches. There should be a compliance calendar and internal audits on periodic basis to prevent any delays in registration next time.

Reflective Questions

What's the reason why in GST Law we have to take separate registration for different states?

How does the theory of "separate corporate personalities" affect stock transfers between children?

Is it right that SMEs do not exhibit in interstate trade fairs as they don't have CTP compliance? Discuss.

How can late registration penalties be avoided by improved compliance planning?

Would optional initial finance registration had helped BrightMart? Why or why not?

Conclusion

The matter pertaining to BrightMart Retail Pvt. Ltd. is a case in point which demonstrates that despite GST registration and adhering to the provisions and limitations, businesses could still be subjected to litigation.

for accountability, can prove challenging for growing companies. The different state wise registrations, temporary CTP registration, penalty for delay and special provisions for UIN entities show how compliance can be complex. But these issues can be addressed through forward planning, technology adoption, staff development and a culture that focuses on compliance. Lastly, GST registration is not only a legal mandate but serves as a strategic device to establish trust and maintain constant business growth In the vibrant economy of India.