BASIC CONCEPTS

INCOME TAX LAW : AN INTRODUCTION

By,

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WHAT IS A TAX?

- **Let us begin by understanding the meaning of tax. Tax is a fee charged by a government on a product, income or activity.**

- **There are two types of taxes . Direct taxes and indirect taxes.**

- **If tax is levied directly on the income or wealth of a person, then it is a direct tax e.g. income-tax, wealth tax.**

- **If tax is levied on the price of a good or service, then it is called an indirect tax e.g. excise duty, custom duty, service tax and sales tax or value added tax. In the case of indirect taxes, the person paying the tax passes on the incidence to another person.**

WHY ARE TAXES LEVIED?

- **The reason for levy of taxes is that they constitute the basic source of revenue to the government. Revenue so raised is utilised for meeting the expenses of government like defence, provision of education, health-care, infrastructure facilities like roads, dams etc.**

OVERVIEW OF INCOME-TAX LAW IN INDIA

- **Income-tax is the most significant direct tax. In this material, we would be introducing the students to the Income-tax law in India. The income-tax law in India consists of the following components.**

- **Income Tax Act**
- **Annual Finance Acts**
- **Income Tax Rules**
- **Circulars/Notifications**
- **Legal decisions of Courts**

Income-tax Act

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

The Finance Act

- **Every year, the Finance Minister of the Government of India presents the Budget to the Parliament.**
- **Part A of the budget speech contains the proposed policies of the Government in fiscal areas.**
- **Part B of the budget speech contains the detailed tax proposals.**
- **In order to implement the above proposals, the Finance Bill is introduced in the Parliament.**
- **Once the Finance Bill is approved by the Parliament and gets the assent of the President, it becomes the Finance Act.**

Income-tax Rules

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

Circulars and Notifications

- Circulars are issued by the CBDT from time to time to deal with certain specific problems and to clarify doubts regarding the scope and meaning of the provisions.

- These circulars are issued for the guidance of the officers and/or assessees.

- The department is bound by the circulars. While such circulars are not binding the assessees they can take advantage of beneficial circulars.

Case Laws

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

LEVY OF INCOME-TAX

- **Income-tax is a tax levied on the total income of the previous year of every person. A person includes**

- **An individual,**
- **Hindu Undivided Family (HUF),**
- **Association of Persons (AOP),**
- **Body of Individuals (BOI),**
- **A firm,**
- **A company etc.**

CONCEPT OF INCOME

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

- **Income, in general, means a periodic monetary return which accrues or is expected to accrue regularly from definite sources. However, under the Income-tax Act, even certain income which do not arise regularly are treated as income for tax purposes e.g. Winnings from lotteries, crossword puzzles.**

- **Income normally refers to revenue receipts. Capital receipts are generally not included within the scope of income. However, the Income-tax Act has specifically included certain capital receipts within the definition of income e.g. Capital gains – gains on sale of a capital asset like land.**

- **Income means net receipts and not gross receipts. Net receipts are arrived at after deducting the expenditure incurred in connection with earning such receipts. The expenditure which can be deducted while computing income under each head.**

- **Income is taxable either on due basis or receipt basis. For computing income under the heads 'Profits and gains of business or profession' and 'Income from other sources' the method of accounting regularly employed by the assessee should be considered, which can be either cash system or mercantile system.**

- **Income earned in a previous year is chargeable to tax in the assessment year.**

- **Previous year is the financial year, ending on 31st March, in which income has accrued/ received.**

- **Assessment year is the financial year (ending on 31st March) following the previous year. The income of the previous year is assessed during the assessment year following the previous year. .**

TOTAL INCOME AND TAX PAYABLE

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

- **Step 1 Determination of residential status**
- **Step 2 Classification of income under different heads**
- **Step 3 Exclusion of income not chargeable to tax**
- **Step 4 Computation of income under each head**
- **Step 5 Clubbing of income of spouse, minor child etc.**
- **Step 6 Set-off or carry forward and set-off of losses**
- **Step 7 Computation of Gross Total Income.**
- **Step 8 Deductions from Gross Total Income**
- **Step 9 Total income**
- **Step 10 Application of the rates of tax on the total income**
- **Step 11 Surcharge**
- **Step 12 Education cess and secondary and higher education cess**
- **Step 13 Advance tax and tax deducted at source**

Step 1 . Determination of residential status

- **The residential status of a person has to be determined to ascertain which income is to be included in computing the total income. The residential statuses as per the Income-tax Act are shown below .**

Residential status under Income Tax Act !961		
Resident		Non-resident
Resident And ordinary resident	Resident but not-ordinary resident	

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

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

Step 2 . Classification of income under different heads

HEADS OF INCOME: The Act prescribes five heads of income.				
SALARIES	INCOME FROM HOUSE PROPERTY	PROFITS AND GAINS OF BUSINESS OR PROFESSION	CAPITAL GAINS	INCOME FROM OTHER SOURCES

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

Step 3 - Exclusion of income not chargeable to tax

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

Step 4 - Computation of income under each head

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

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

- **In case of individuals, income-tax is levied on a slab system on the total income. The tax system is progressive i.e. as the income increases, the applicable rate of tax increases.**

- **Some taxpayers in the higher income bracket have a tendency to divert some portion of their income to their spouse, minor child etc. to minimize their tax burden. In order to prevent such tax avoidance, clubbing provisions have been incorporated in the Act, under which income arising to certain persons (like spouse, minor child etc.) have to be included in the income of the person who has diverted his income for the purpose of computing tax liability.**

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

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

- Similarly, an assessee can have loss under one head of income, say, Income from house property and profits under another head of income, say, Profits and gains of business or profession. There are provisions in the Income-tax Act for allowing inter-head adjustment in certain cases.

- Further, losses which cannot be set-off in the current year due to inadequacy of eligible profits can be carried forward for set-off in the subsequent years as per the provisions contained in the Act.

Step 7 . Computation of Gross Total Income.

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

Step 8 . Deductions from Gross Total Income

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

Deduction in respect of certain payments	Deduction in respect of certain incomes	Other deductions
1. Life insurance premium paid 2. Contribution to provident fund/ Pension fund 3. Medical insurance premium paid 4. Payment of interest of loan taken for higher education 5. Rent paid 6. Certain donations 7. Contribution to political parties	1. Profit and gains from undertaking engaged in infrastructural development 2. Profit and gains from undertaking engaged in development of SEZ 3. Certain income of co-operative societies 4. Royalty income etc of authors 5. Royalty on patents	Deduction in case of person with disability

Step 9 . Total income

- **The income arrived at, after claiming the above deductions from the Gross Total Income is known as the Total Income.**

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

- **The rates of tax for the different classes of assesses are prescribed by the Annual Finance Act. The tax rates have to be applied on the total income to arrive at the income-tax liability.**

Step 11 . Surcharge

- **Surcharge is an additional tax payable over and above the income-tax. Surcharge is levied as a percentage of income-tax.**

Step 12 . Education cess and secondary and higher education

Cess on income-tax

- The income-tax, as increased by the surcharge, is to be further increased by an additional surcharge called education cess@2%. The Education cess on income-tax is for the purpose of providing universalised quality basic education. This is payable by all assesses who are liable to pay income-tax irrespective of their level of total income.

- Further, .secondary and higher education cess on income-tax. @1% of income-tax plus surcharge, if applicable, is leviable from A.Y.2008-09 to fulfill the commitment of the Government to provide and finance secondary and higher education.

Step 13 - Advance tax and tax deducted at source

- Although the tax liability of an assessee is determined only at the end of the year, tax is required to be paid in advance in certain instalments on the basis of estimated income.

- In certain cases, tax is required to be deducted at source from the income by the payer at the rates prescribed in the Act. Such deduction should be made either at the time of accrual or at the time of payment, as prescribed by the Act.

- For example, in the case of salary income, the obligation of the employer to deduct tax at source arises only at the time of payment of salary to the employees. Such tax deducted at source has to be remitted to the credit of the Central Government through any branch of the RBI, SBI or any authorized bank. If any tax is still due on the basis of return of income, after adjusting advance tax and tax deducted at source, the assessee has to pay such tax (called self-assessment tax) at the time of filing of the return.

RETURN OF INCOME

- The Income-tax Act, contains provisions for filing of return of income.
- Return of income is the format in which the assessee furnishes information as to his total income and tax payable. The format for filing of returns by different assessees is notified by the CBDT.
- The particulars of income earned under different heads, gross total income, deductions from gross total income, total income and tax payable by the assessee are required to be furnished in a return of income.
- In short, a return of income is the declaration of income by the assessee in the prescribed format.
- The Act has prescribed due dates for filing return of income in case of different assessees. All companies and firms have to mandatorily file their return of income before the due date.
- Other persons have to file a return of income if their total income exceeds the basic exemption limit.