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# LECTURE-02

# TERMS AND CONCEPT ON INCOME TAX

**Components of Income Tax Act**

- The Income Tax Act is a self-contained Act. Sections 2 and 3 define the terms/expressions used in the Income Tax Act. The word ‘means’, ‘includes’ are used in the definitions and the significance of these terms needs to be understood.
- When a definition uses the word ‘means’, the definition is self-explanatory, restrictive and in a sense, exhaustive. It implies that the term or expression so defined means only as to what it is defined as and nothing else. For example, the terms ‘Agricultural Income’, “Assessment year”, ‘Capital Asset’ is exhaustively defined.
- When the legislature wants to widen the scope of the term or expression and where an exhaustive definition cannot be given, it uses the word ‘includes’ in the definition. Hence, the inclusive definition provides an illustrative meaning and not an exhaustive meaning. In practical application, the definition could include what is not specifically stated or mentioned in the definition as long as the stipulated criteria are satisfied. To illustrate, reference is drawn to the definition of the terms ‘Inclines,’ ‘Person’, ‘Transfer’.
- When the legislature intends to define a term or expression to mean something and also intends to specify certain items to be included, both the words ‘means’ as well as ‘includes’ are used. Such a definition is not only exhaustive but also illustrative. Example: the terms ‘assessee’, ‘Indian company’, “Recognised Provident Fund”.
- Since income tax is levied on the 'income' of an entity, it is important to know what income is and how it is computed.

**Income**

- Though the term income is not defined in an exhaustive manner under the Act, generally speaking, it includes receipts in the shape of money or money’s worth which arise with certain regularity or expected regularity from a definite source.
- The expression ‘income’, according to the dictionary, means ‘a thing that comes in’. Income may also be defined

as the gain derived from land, capital or labour or any two or more of them.

- ‘Income’ in this Act connotes a periodical monetary return ‘coming in’ with some sort of regularity or expected regularity. The word ‘income’ is not limited by the words ‘profits’ and ‘gains’. Anything which can properly be described as ‘income’, is taxable under the Act unless expressly exempted

Section 2(24) gives a statutory meaning of the term ‘Income’. The section does not define the term Income but merely describes various receipts as income. At present the following items of receipts are included in income u/s 2 (24)

- Profits and gains
- Dividends
- Voluntary contributions received by a trust/institution created wholly or partly for charitable or religious purposes or by an association or institution covered by Section 10 (21) or (23) or (23C) (iv) or (v).
- The value of any perquisite or profit in lieu of salary taxable and Section 17.
- Any special allowance or benefit other than the perquisite included above, specifically granted to the assessee to meet expenses wholly, necessarily and exclusively for the performance of the duties of an office or employment for private purposes.
- Any allowance granted to the assessee to meet his personal expenses at the place where the duties of his or employment of profit are ordinarily performed by him or at a place where he ordinarily resides or to compensate him for the increased cost of living.
- The value of any benefit or perquisite whether convertible into money or not, obtained from a company either by a director or by a person who has a substantial interest in the company or by a relative of the director or such person and any sum paid by any such company in respect of any obligation which, but for such payment would have been payable by the director or other person aforesaid.
- The value of any benefit or perquisite, whether convertible into money or not, which is obtained by any representative assessee mentioned in clauses (iii) and (iv) of Section 60(1) or by any beneficiary or any amount paid by the representative assessee for the benefit of the beneficiary which the beneficiary would have ordinarily been required to pay.
- Value of any benefit or perquisite, whether convertible into money or not arising from business or exercise of profession.
- Any sum chargeable to income tax under Section 41 and Section 59.
- Any sum chargeable to income tax under (ii), (iii), (iii-a), (iii-b), (iii-c), (iv) and (v) of Section 28.
- Any sum chargeable to tax v/s 28(v) [interest, salary, bonus, commission or remuneration to a partner of a firm].
- Any capital gains chargeable under section 45.

- The profits and gains of any insurance carried on by Mutual Insurance Company or by a co-operative society, computed in accordance with section 44 or any surplus taken to be such profits and gains by virtue of the provisions contained in the first Schedule to the Act.
- Any winnings from lotteries, cross-word puzzles, races including horse races, card games and other games of any sort or from gambling or betting of any form or nature whatsoever.
- Any sum received by the assessee from his employees as contribution to any provident fund or superannuation fund or employees state insurance fund or any other fund for the welfare of such employees.
- Any sum received under a Lump sum Insurance policy including sum allocated by way of bonus in such policy.
- Any sum received/receivable as specified in Sec. 28 (va) [i.e., Sum received in cash or kind under an agreement

for not carrying out any activity in relation to business or not to share any knowhow, patent, etc.]

- Gifts: Taxability of certain receipts/credits to be regarded as income if received on or after 1st September 2004. Interestingly, the provision does not use the word 'Gift'.
- The definition of 'income' of an individual or HUF will now include any sum received from any person on or after 1 September 2004 in cash or cheque or by any other mode or credit, otherwise than as consideration for goods or services. However, this would not include the following:

1. Amounts received by an individual from a relative out of natural love and affection. The term 'relative' has been specifically defined for this purpose.
2. Amounts received by an individual or HUF under a will or by way of an inheritance.
3. Amounts received by an employee/dependant of a deceased employee from an employer by way of bonus, gratuity or pension or insurance or any other sum solely in recognition of services rendered.
4. Amounts received in contemplation of death of an individual or Karta or member of HUF.
5. Any income exempt under section 10 or otherwise or which is excluded from total income.
6. Amounts received on transactions not regarded as 'transfer' for the purpose of capital gains.

- A general exemption of Rs. 25,000 per year in the aggregate will be available in respect of the receipts/credits mentioned above. In addition, gifts received on marriage will be exempted.
- The income of the nature described above will be taxable under the head 'Income from other sources'.

- Based on the above, gifts received on any occasion other than marriage, unless specifically excluded will be

treated as income.

### 1.3.1 Capital and Revenue Receipts

The Income Tax Act charges tax on income and not on capital and hence it is very essential to distinguish between capital and revenue receipts.

The Income Tax Act does not define the term “Capital Receipts” and “Revenue Receipts”. Therefore, whether a certain receipt is capital or revenue would be a mixed question of law and fact. It is to be determined on the basis of the particular facts and circumstances of each case.

The following are some of the important rules which guide in making a distinction between them.

- A receipt referable to fixed capital would be a capital receipt whereas a receipt referable to circulating capital would be a revenue receipt: Circulating capital is the capital which is turned over and in the process of being turned over, yields profit or loss e.g., fixed capital is also involved in this process but remains unaffected by the process. A capital asset in the hands of one person may be a trading asset in hands of another. Thus, while determining the nature of receipt, one has to consider the nature of trade in which the asset is employed.
- A receipt in substitution of a source of income is a capital receipt whereas a receipt in substitution of an income is a revenue receipt: Compensation for loss of employment is a capital receipt; whereas compensation for temporary disablement is a revenue receipt.
- Compensation received from Government in respect of stock in trade destroyed or damaged by enemy action constitutes revenue receipts. On the contrary, compensation paid for acquisition of land or property which constituted capital asset in the hands of the lessee would be a capital receipt.
- An amount received as a compensation for the surrenders of certain rights under an agreement is a capital receipt: E.g., If a director/partner receives an amount from the company in consideration of giving up his right to carry on competitive business similar to that of a company/ firm; it will be a capital receipt. An amount received as a compensation for loss of future profits is a revenue receipt.
- Receipt to be of a revenue nature need not necessarily be repetitive or recurring: Thus, a bulk purchase followed by bulk sale or a series of retail sales would constitute an adventure in

the nature of trade and consequently income arising there from would be taxable.

- **Nature of receipt in the hands of recipient:** The easiest example to understand is the case of a builder. If he sells a particular property or a flat, he would be receiving the monies on revenue account as they constitute his stock in trade, whereas it does not matter that the person making the payment would consider the payment on capital account.

- **Annuity:** For annuities which are payable in specified sums at periodic intervals of time, the receipt would be of a revenue nature. The fact that annuity is contingent or variable in amount does not in anyway affects its charter as income. An annuity received from an employer is taxable as "income from salaries" whereas all other annuities are chargeable under the head - income from other sources irrespective of the fact whether or not they are payable: (i) Under a deed of family arrangement (ii) Under a deed of separation to a wife or (iii) Under a degree for alimony or (iv) To the estate of the deceased partner by the remaining partners for the use of firm's name and goodwill. Annual payments (i.e., annual instalments) as distinguished from annuities are in the nature

of capital. Thus, the amount of instalment received by the assessee would be of capital nature and hence not liable to tax. In order to ascertain whether a certain payment is an annuity or annual instalment, regard must be had to the true nature and character of a transaction, for example,

② If the sale of property/business is for a price which is to be paid in instalments, the instalments would be capital receipts.

② If the property is sold for an annuity payable regularly, the property disappears and the annuity assumes the
character of definite income and hence chargeable to tax.

- **Lump sum receipts:** In order to determine whether a receipt is capital or revenue in nature, the fact that it is a lump sum payment, large payment or periodic payment is not relevant. A lump sum paid in commutation of salaries, pension, royalties or other periodic payments would be income, taxable under the respective heads. Similarly, royalties received for use of patents, whether paid in lump sum or in instalments of fixed or varying amounts would be taxable as income. However if the payment received is in lieu of total or partial assignment of patent under which the owner ceases to own patent as a capital asset, it would constitute a capital receipt.

**Receipts Bereft of Revenue Element**

All receipts are not income. Particular receipt cannot be taxed because they cannot be proved to be a taxable income at all. Knowledge of such receipts is essential to understand the meaning of the term 'Income'.

- Surplus arising to mutual concerns (concept of mutuality): One cannot make a profit from dealing with oneself. Income should be received from outside. If a person re-values his goods/assets and shows a higher value in books, he cannot be considered as having sold the goods and make a profit thereon. Similarly, in case of mutual concerns (Clubs, associations and society) if subscription from members exceeds its expenditure on its members, excess cannot be treated as taxable income.
- Pin Money: Pin money received by wife for her dress/personal expenses and small savings made by a woman out of money received from her husband for meeting household expenses is not treated as her income.

**Rates of Tax**

Income tax is to be charged at the rates fixed for the year by the annual Finance Act. The Finance Act consists of three schedules at the end of it. The last schedule consists of four parts. Let us take the example of Finance Act, 2005 –

- Part I consists of rates of tax applicable to income of various types of assessee for the assessment year
- Part II. consists of rates of deduction of tax in certain cases.
- Part III consists of rates for deduction of tax from salary and also for computing advance tax.
- Part IV gives rules for the computation of Net Agricultural income.

**Defining 'Person'**

The term 'person' includes:

- An individual
- A Hindu Undivided Family
- A company
- A firm
- An association of persons or body of individuals whether incorporated or not
- A local authority and
- Every artificial juridical person not falling within any of the preceding categories

The definition is inclusive and not exhaustive. Therefore any person not falling in the above seven categories may
still fall in the term person and accordingly may be liable to Income tax

- **Individual:** The expression 'individual' as a unit of assessment refers only to a natural person i.e., a human being; deities and statutory corporations are assessable as 'juridical person'. Individual includes a minor and a
person of unsound mind.
- **Hindu Undivided Family:** Family con notes a group of people related by blood or marriage. The word family always signifies a group. Plurality of persons is an essential attribute of a family. A single person, male or female, does not constitute a family. He or she would remain, what is inherent in the very nature of things, an individual, till per chance he or she finds a mate. The expression 'Hindu Joint family' in the Income Tax Act is used in the sense in which a Hindu joint family is understood under the various schools of Hindu law. The word 'Hindu' preceding the words 'undivided family' signifies that the undivided family should be of those to whom Hindu law applies.
- **Company:** Under Sec. 2(17), the expression 'Company' is defined to mean the following:
    1. An Indian company or
    2. Any body corporate incorporated under the laws of a foreign country or
    3. Any institution, association or a body which is assessed or was assessable as a company for any assessment year commencing on April 1, 1970 or
    4. Any institution, association or a body, whether incorporated or not and whether, Indian or non-Indian which is declared by general or special order of the Central Board of Direct Taxes to be a company.
- **Firm:** 'Firm' is a collective noun, a compendious expression to designate an entity, not a person. Under the Income tax Act, 'firm', 'partner' and 'partnership' have been given the same meaning as assigned to them in the Indian Partnership Act. But the expression 'partner' has been extended to include any person who, being a minor, has been admitted to the benefits of a partnership. Only the members who have entered into partnership are to be regarded as partners and collectively a firm and the name under which their business is carried on, is called the firm's name.
- **Association of Persons (AOP):** An association of persons must be one in which two or more persons join in a common purpose or common action and as the word occurs in section 3 of the 1922 Act, which imposes a tax on income, profits or gains, the association

must be one the object of which is to produce income, profits or gains.

- **Body of Individuals:** The expression 'body of individuals' includes a combination of individuals who have a unity of interest but who are not actuated by a common design and one or more of whose members produce or help to produce income for the benefit of all. Distinction between Association of Persons and Body of Individuals

  An Association of Persons may consist of non-individuals but a Body of Individuals has to consist only of individuals. If two or more persons (like firms, company, HUF, individual, etc.) join together, it is called an Association of Persons.

  An Association of Persons implies a voluntary getting together for a common design or combined will to engage in an income producing activity, whereas a Body of Individuals may or may not have such common design as well.
- **A Local Authority:** This includes,
  - Panchayat as referred to in Article 243(a) of the Constitution; or
  - Municipality as referred to in Article 243 P of the constitution.
  - Municipal Committee and Dish net Board, legally entitled or entrusted by the Government with, the Central or management of a Municipal or local funds.
  - Cantonment Board as defined in Sec. 3 of the Cantonment Act, 1924.
  - Artificial person: Artificial persons are entities, which are not natural persons but are separate entities in the eyes of law. Though they may not be sued directly in a court of law, but they can be sued through the persons managing them e.g., gods, idols and deities are artificial persons.

**Assessee**

An assessee is a person by whom any tax or any other sum of money (for example interest, penalty, fine, etc.) is payable under the Income Tax Act and includes:

- A person in whose respect proceedings for determining income or for assessment of fringe benefits or of the income of any other person in respect of which he is assessable or of the loss sustained by him or by such other person or of the amount of refund due to him or to such other person; have been commenced by the Income Tax Department.

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- Thus, a person may become an assessee even if no amount is payable by him under the Income Tax Act.
- A deemed assessee is a person who is himself not an assessee but is treated as an assessee for the purposes of the Income Tax Act. For example, the trustee of a trust is a deemed assessee in respect of the trust. The income earned is the income of the trust but is assessed in the hands of the trustee as his income.
- An assessee in default is a person on whom certain obligations have been imposed under the Income Tax Act but who has failed to carry out those obligations. For example, any person who employs another person has to deduct income tax at source from the taxable salary of the employee and pay the tax deducted at source to the government within the prescribed time as income tax paid on behalf of the employee. In case the employer fails to carry out these obligations, he becomes an assessee in default.

**Assessment Year (AY) [Sec. 2(9)]**

- Assessment year (AY) means the financial year ($1^{st}$ April to $31^{st}$ March of next year) in which the income is taxed or assessed. Income of the previous year is taxed in the assessment year (next year) at the rates prescribed by the relevant finance Act

**Previous Year [Sec. 2(34) and Sec. 3]**

- Previous year (PY) means the financial year immediately preceding the assessment year. In case of a business or profession which is newly started, the previous year commences from the date of commencement of the new business or profession up to the next $31^{st}$ day of March.

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